Market Commentary

October 2014

- **Emerging market equities outperformed developed market equities.**
- **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 closed up marginally in October, a month marked by some notable macro news. In the US, the Federal Reserve ended its monetary easing program. In Japan, the Bank of Japan surprised markets with news that it will be aggressively expanding its asset purchase program. Elsewhere in Asia, anti-government protests continued in Hong Kong. In Europe, growth concerns resurfaced amidst disappointing German economic data. To top it off, crude oil prices saw a huge sell-off in October. Emerging market equities outperformed their developed market peers as represented by the MSCI World Index. The MSCI Emerging Markets Index gained 1.19%, while the MSCI World Index and the S&P 500 Index rose 0.73% and 2.44%, respectively.

Chinese equities were relatively strong in October and outperformed their emerging market peers as the MSCI China Index closed up 4.31% in USD terms. This gain occurred against a backdrop of a slowing economy as China's third quarter GDP registered growth of 7.3% year-over-year, somewhat higher than expected, but lower than the government's full-year 7.5% target. Other economic indicators generally were in-line with market expectations, as HSBC manufacturing PMI improved slightly to 50.4 in October from 50.2 in September and August, and industrial production picked up, increasing 8% year-over-year in September, from 6.98% in August. On the policy front, government reforms continued to show progress.

Indian equities also moved upward and outperformed their emerging market peers in October, with the MSCI India Index gaining 4.20% in USD terms. News on both the economic and policy fronts were mainly supportive during the month. HSBC manufacturing PMI increased to 51.6 in October from 51.0 in September while inflation fell in September to its lowest level since January 2012, helped by a sharp decline in food and oil prices. Importantly, on the policy front, a number of energy reforms, including the end of diesel subsidies, were announced by the government. These reforms should help India rein in its fiscal deficit. State election results also continue to move in favor of Prime Minister Modi's Bharatiya Janata Party, paving the way for a faster rollout of reforms.

Brazilian equities lagged the broader emerging market benchmark as the MSCI Brazil Index rose just 0.52% in USD terms. The market was disappointed by the election victory of incumbent President Dilma Rousseff, as evidenced by the sell-off in the currency and equities, led by the energy sector. Markets rebounded at the end of

the month after the central bank surprised the markets with an interest rate increase to 11.5% aimed to stem inflation and support the currency. Sentiment remains uncertain and we anticipate continued market volatility in the period leading up to Rousseff's appointment of key government figures.

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 12.6x, whereas the MSCI World Index trades at 17.6x and the S&P 500 Index trades at 17.8x. Historically,[1] these indices have traded at 14.5x, 21.3x, and 19.3x, respectively.[2]

China

Market Update

Following a correction in September, the Chinese market registered small ups and downs throughout the month, but ended in positive territory with the MSCI China Index up 4.31% in USD terms. Macro indicators were generally in-line with expectations at growth levels similar to previous months. HSBC manufacturing PMI improved slightly to 50.4 in October from 50.2 in September and August. Industrial production also picked up, increasing 8% year-over-year in September, from 6.9% in August, while retail sales growth slowed slightly to 11.6% in September from 11.9% in August. Export growth declined to a rate of 11.6% year-over-year in October, down from 15.3% in September, and import growth fell to 4.6% from 7.0% in September. Meanwhile, inflation remained near a multi-year low of 1.6%, underscoring the soft consumption trend and sparking fears of deflation.

In addition to the stagnant macro data, the market was also weighed down by the delay of the Hong Kong-Shanghai Stock Connect, which will allow direct trading of shares between Hong Kong and mainland China. As anticipation of the scheme has been a positive driver of market sentiment in recent months, disappointment over the delay appears to have contributed to the weak trend. On the other hand, President Xi Jinping's "One Belt and One Road" initiative, which aims to increase economic ties between China and its neighbors, is starting to take shape, potentially becoming a market catalyst. In late September, a plan was submitted to the State Council calling for $16.3 billion to finance the construction of railways, roads and pipelines for the "New Silk Road."

Investment Outlook

Looking forward, we believe that market momentum will pick up as we approach the end of the year. Now that the government has begun to gain control over shadow banking and local government debt issues, we believe that it will continue to loosen policy. However, we anticipate targeted pro-growth measures versus large-scale stimulus. We also expect the Hong Kong-Shanghai Stock Connect to launch soon, reviving positive sentiment for this initiative.

Given the current weak trend, we see opportunities in the consumer, energy and information technology sectors. Within energy, we particularly like green energy, shale gas, and anti-pollution segments as expansion of these areas are not only about health concerns and China's global image, but also lowering its reliance on energy imports. We have become less constructive on financials, including the insurance and property subsectors. Even though local government property policies are loosening, we believe the overall property market's growth potential is shrinking.

While China's GDP growth rate will not approach the level seen in recent years and domestic demand is likely to remain soft over the near term, we believe consumer and service areas of the economy will offer attractive investment opportunities as China continues its transition from an investment-driven, high-growth economy to a consumption/service-oriented market with more quality growth opportunities. For this reason, we remain constructive on the healthcare and consumer sectors as we believe both have reasonable valuations and are seeing increased earnings growth. Additionally, given that the "New Silk Road" plan is likely to be approved, engineering and construction companies should benefit from the government's strong support of this initiative.

India

Market Update

Driven by the announcement of oil reforms, the Indian market moved higher in October, with the MSCI India Index gaining 4.20% in USD terms. During the month, the government announced a number of energy related reforms that were welcomed by the market, including deregulation of diesel prices and approval of a new gas price policy, which should help the country control its fiscal deficit. Improving macro data also helped buoy market sentiment. Inflation fell in September to its lowest level since January 2012, with the CPI growing 6.46% year-over-year, down from 7.8% in August. In particular, food and oil inflation declined sharply. HSBC manufacturing PMI inched

[1]Historical averages since 1996
[2]Bloomberg, as of 10/31/14

up to 51.6 in October from 51.0 in September. Export growth picked up to 2.7% year-over-year in September, from 2.4% in August, but a surge in gold demand pushed imports up 26%, creating a monthly trade deficit of $14.2 billion, the highest in 18 months.

On the political front, state election results continued to move in favor of the Bharatiya Janata Party, with victories in two state assembly elections in October. India now has a more consolidated government than it has had over the last few decades, paving the way for even faster rollout of reforms.

Investment Outlook

Following the euphoria of May's election result, it appears that the Indian market has moved past a number of overhangs that had started to weigh on investor sentiment, including sticky oil prices and ongoing inflation pressure, a disappointing monsoon season, the lack of detail in the Union Budget, and higher valuations following the post-election rally. Oil prices have fallen sharply with Brent oil declining $25 per barrel over the last four months, inflation has eased to its lowest level in nearly three years, and real breakthroughs in policy reform are beginning to emerge. On the economic front, early signs of improvement should further support the market.

We believe politics and policy will continue to play a key role in India's economic rebound, particularly in reviving the country's near-frozen infrastructure development. Real improvement in policy implementation and execution are crucial to India's economic growth. We remain encouraged by the increasing visibility of policy initiatives to clear the bottleneck of infrastructure projects, including the exemption of some projects from the requirement to obtain environmental clearance.

Within infrastructure, we continue to be highly selective in the private sector, focusing on the health of company balance sheets. We prefer quality names with proven track records in delivery and execution, and solid cash flows. In particular, we like the road, port and cement subsectors, given their recurring income business models and relatively competitive landscapes. On the other hand, we remain cautious of the power segment due to ongoing bottlenecks and less healthy balance sheets.

The Association of Southeast Asian Nations (ASEAN)

Market Update

Performance across the ASEAN region was largely flat in USD terms during October with Indonesia and Malaysia slightly outperforming Thailand and the Philippines.

In Indonesia, Joko Widodo (Jokowi) was sworn in as the new president, soon after which he announced his new cabinet, garnering mixed reviews. While some were disappointed by the limited change in structure, there was also enthusiasm that some posts were filled by professionals who have a history of fixing problems. On the economic front, macro data continued to reflect an economy under pressure. Though GDP growth momentum has continued to slow, monetary policy remains unchanged as inflation continues on an upward trajectory, increasing 4.83% year-over-year in October, from 4.53% in September.

Within the ASEAN region, declining oil prices had varying impact. In Malaysia, lower fuel and food prices contributed to a notable decrease in inflation, from around 3.2% over the last four months to a rate of 2.6% year-over-year in September. As the only oil exporter in the region, Malaysia's dependence on the oil industry for fiscal revenue has led to concerns over weakening economic growth. At the same time, the government's recent fuel subsidy cut will make oil more expensive to Malaysian consumers and increase inflationary pressure. In Indonesia, inflation continues to rise in anticipation of a fuel subsidy cut, despite lower global oil prices. Inflation in Thailand eased for a fifth consecutive month to 1.48% year-over-year in October, while inflation in the Philippines has decelerated over the last two months after peaking at a rate of 4.9% in August.

Investment Outlook

We maintain a mostly positive long-term outlook for the ASEAN region, as new or revived infrastructure plans have the potential to significantly change the economic structure of the region. That said, each country is being impacted by its own set of fundamentals.

In Indonesia, though we remain constructive that Jokowi will establish a new way of governing, it will not be easy given his fractured mandate, with the Red and White coalition dominating the upper and lower houses of parliament. Additionally, the country's slowing growth momentum continues to be a concern, particularly as rising inflation provides the central bank with very little room to loosen monetary policy. We also remain cautious on Malaysia in light of lower oil prices and the economy's dependence on oil revenue. The government's plan to reduce the fiscal deficit from an estimated 3.5% of GDP in 2014 to 3% in 2015 by cutting subsidies and implementing a goods and services tax could lessen the impact.

In Thailand, though political issues remain, expectations are high that long-delayed infrastructure projects will finally move forward as the current junta government implements plans to develop the country's land and rail transport systems. We also remain positive that the Philippines' structural growth story will continue, particularly now that inflationary pressure has begun to ease.

At the sector level, we prefer healthcare, infrastructure-related names, and tourism given the notable influx of Chinese tourists, but are less constructive on the energy and financial sectors.

Brazil/Latin America

Market Update

The Brazilian market consolidated in October with the MSCI Brazil Index ending flat with 0.52% in USD terms, as investors began to price in the victory of incumbent President Dilma Rousseff over the market-favorite candidate Aecio Neves. As one of the sectors most likely to benefit from reforms if Neves had won, the energy sector experienced the biggest decline for the month given the status quo election result.

The Latin America region overall declined slightly for the month and showed increased volatility as Brazil concluded its tightest election in years. Chili, which has underperformed year-to-date, outperformed in October as greater clarity on tax reform and lower energy prices lifted investor sentiment.

Investment Outlook

Throughout 2014, hope for an opposition victory and subsequent structural reforms in the areas of labor, taxation and infrastructure led to a decoupling of the Brazilian market from its weak underlying economy. With the election finally behind it, the Brazilian market should again be driven by the economic landscape and company fundamentals. However, politics will continue to play a role as the market will closely watch the appointments of key figures for signs of positive change and any indications that market-desired reforms will be given priority in Rousseff's second term. While there are concerns that the strengthening Brazilian real, which had been appreciating in anticipation of a different election outcome, could reverse, a weaker currency could be a significant tailwind to exports sectors that have underperformed year-to-date.

Despite the conclusion of the election, our outlook hasn't changed significantly. We have a continued preference for structural growth stories including insurance, financial services and retailing. We remain positive on 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 financials, real estate and consumer sectors, where there is dividend and buyback support at current levels. We are also growing more constructive on export sectors, as the currency could depreciate against the US dollar in line with other emerging markets. We are less constructive on the telecom sector, where the potential for M&A is already priced in.

Across Latin America, we prefer Mexico and Peru over Chile and Colombia. That said, though we have not seen much value in Colombia so far this year, we are starting to turn more positive. We are relatively neutral on Brazil as we await news of government appointments and any reform announcements, and because we believe Brazil faces a difficult year ahead as both fiscal and monetary tightening will weigh on the market. We remain structurally positive on the investment case in Mexico, while in Chile, Colombia and Peru we continue to focus on individual areas where we see value. On a sector basis, we like financials and secular consumer growth stories including casual dining, insurance and education. We hold a less constructive outlook for the telecom, utilities and energy sectors.

Eastern Europe, Middle East and Africa (EEMEA)

Market Update

The MSCI Russia Index fell 2.04% in USD terms in October. Though the ruble again depreciated significantly against the US dollar, this helped to alleviate some of the pressure caused by lower commodity prices. On the political front, the elections in Ukraine concluded peacefully with the pro-EU coalition winning as expected. However, the Eastern Ukraine regions involved in the conflict will have their own elections and Russia has stated that it intends to officially recognize these elections. This could cause conflict between Russia and the EU, lowering the probability that sanctions will be lifted.

The picture across Eastern Europe was mixed. While the Russian ruble depreciated 8% against the US dollar, making it the weakest emerging market currency, the Turkish lira appreciated 2%. Turkey rallied on softer commodity prices, which help to relieve some of the pressure imposed by its large current account deficit.

The Middle East/Africa region outperformed for the month, led by South Africa, which, similar to Turkey, saw its currency appreciate on lower commodity prices. In contrast, the US dollar-linked markets of United Arab Emirates and Qatar underperformed.

Investment Outlook

The Russian central bank has already moved to defend the ruble by increasing interest rates, and is also expected to end currency bands before year-end. Even though the floating currency will act as a balancing mechanism for lower commodity prices, it is likely to lead to inflation with respect to imported goods. Higher interest rates and rising import inflation, combined with ongoing sanctions, weak external demand, and lower commodity prices, all point to negative growth in the near term. On a more positive note, we expect exporters to benefit from the weaker currency, and food retailers to see improved margins on higher food inflation, at least until food inflation becomes a political issue. We remain highly cautious of domestic banks and companies that have high refinancing or funding needs.

Across Eastern Europe, we have adopted a more moderate outlook for Russia where we continue to prefer high-quality private companies that experience limited state interference, as well as certain cheap cyclicals focused on cutting capital expenditures and increasing dividends. We are growing more constructive on Turkey as we see short-term benefits from more European Central Bank actions and lower commodity prices, which should help to reduce the current account deficit and further alleviate pressure on the currency, thus supporting economic growth. Even though we saw a strong rebound in fragile markets, including Turkey and South Africa, we remain cautious about the sustainability of this strength until we see improved global data. Within South Africa, we like structural winners that are also beneficiaries of a weaker currency and are relatively immune to higher domestic inflation. We continue to see opportunity in the Middle East, but remain very selective.