Market Commentary

February 2015

- **Emerging market equities underperformed 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 had a strong month in February amidst a rebound in oil prices, a ceasefire for Russia-Ukraine, and favorable developments regarding Greece and its rescue program. Emerging markets delivered positive returns but underperformed their developed market peers. The MSCI Emerging Markets Index gained 3.07% while the MSCI World Index and the S&P 500 Index closed up 5.92% and 5.75%, respectively.

The MSCI China Index maintained its upward trend in February, closing up 3.23% in USD terms and outperforming the broader emerging markets index. Further monetary easing through a surprise cut to the reserve requirement ratio (RRR) buoyed market sentiment; however, recent economic data releases continue to point to soft economic activity. HSBC manufacturing PMI remained in contraction territory at 49.7 in January, while inflation fell to 0.8%, its lowest level in five years. Imports contracted sharply, driven by commodities, and contributed to a record monthly trade surplus of $60 billion for January. Investors will be watching for further signs of monetary stimulus in a slowing growth environment.

After a sharp rally in January, Indian equities again delivered positive returns in February, with the MSCI India Index closing up 2.30% in USD terms. The market was looking forward to the new government's first full-year budget, which was widely expected to be pro-growth. On the macro front, economic data releases were mixed. HSBC manufacturing PMI declined from 52.9 in January to 51.2 in February, and industrial production slowed in December to 1.7% year-over-year, down from 3.9% in November. Inflation remained under control at 5.11% in January, below the central bank's target upper limit of 6%.

In February, the Brazilian equity market broke its negative momentum but again underperformed its emerging market peers, as the MSCI Brazil Index gained 2.86% in USD terms. Two key themes continued to impact the market: the government's planned fiscal consolidation and the ongoing corruption scandal surrounding a major oil producer. In February, the first signs of fiscal tightening measures began to emerge, raising further concerns about Brazil's growth prospects in 2015. With regards to the major oil producer, Moody's downgrade of their credit rating to below investment grade came sooner than expected last month. The negative investor sentiment contributed to further declines in the Brazilian currency.

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 12.8x, whereas the MSCI World Index trades at 18.5x and the S&P 500 Index trades at 18.9x. Historically[1], these indices have traded at 14.4x, 21.2x, and 19.3x, respectively[2].

China

Market Update

The Chinese market maintained its upward trend in February, with the MSCI China Index rising 3.23% in USD terms. Overall market sentiment was positive in anticipation of further monetary stimulus following a surprise 50 basis point cut to the RRR at the beginning of the month. Expectations were met when the central bank also reduced benchmark interest rates by 25 basis points at the end of the month.

While monetary policy is trending in a favorable direction, these moves are in response to continued soft economic activity, as macro indicators reported during the month showed little evidence of a recovery. HSBC manufacturing PMI remained in contraction territory at 49.7 in January, while inflation fell to 0.8%, its lowest level in five years. Both exports and imports contracted. Exports declined 3.3% year-over-year in January and imports fell 19.9%, resulting in a record monthly trade surplus of $60 billion. Both figures missed their consensus estimates by a wide margin as exports were expected to register a 6.3% increase while imports were predicted to decline by just 3%. Together, falling inflation and the sharp decrease in imports again sparked fears of deflation. In recognition of the soft economic environment, the government reduced its growth target for 2015 from 7.5% to 7%.

On the reform front, in line with China's stance on further opening of the economy, the Guangdong provincial government announced a plan to simplify registration procedures in its Free Trade Zone, and create a "negative list," which will narrow the number of industries and activities that are restricted or prohibited from foreign investment.

Investment Outlook

Looking into March, all eyes are on the National People's Congress (NPC), which will provide greater insight into China's growth and fiscal targets as well as its reform agenda for 2015. There is general consensus that monetary easing will continue in the form of both additional interest rate and RRR cuts, and that fiscal drivers, like more infrastructure and construction-related government projects, should be forthcoming. We believe that the most important factor in maintaining positive market sentiment will be the country's reform agenda and how much of it the government is able to achieve in the coming year.

On a sector basis, we believe the consumer, healthcare, IT and new energy sectors are still the most promising in the Chinese economy over the long term. In the short term, healthcare stocks are likely to remain under pressure due to possible price cuts resulting from the tendering process. In general, as policy remains the overriding factor driving the market, we continue to seek opportunities in sectors and stocks that benefit from monetary easing and policy reform.

We have developed a more favorable outlook for the insurance subsector, as interest rate cuts and additional deregulation will support the industry's long-term growth. On the other hand, Macau casinos and food and beverage names have posted negative flows and are experiencing weak earnings trends, leading us to adopt a less constructive view of these industries.

India

Market Update

The Indian market lost momentum following its strong rally in January, but the MSCI India Index still managed to post a 2.30% gain in USD terms for the month led by financials and industrials. The market was influenced by the Union Budget for fiscal year 2015-2016, which was revealed at the end of the month to mixed reviews. Though it was evident that the government's aim was to deliver a pro-growth budget, the fiscal shortfall is expected to stay at 3.9% of GDP as many subsidies for the country's poor were retained. While the budget was devoid of any significant big-bang reforms, the focus was on improving the ease of doing business and tackling infrastructure bottlenecks and utilization of existing assets. Despite some disappointment over fiscal deficit targets, investors were comforted by the conservative revenue/expenditure estimates and the focus on government expenditures to revive economic activity. Outside of the budget, the auctioning of coal blocks, a good precedent for allocation of public resources, was a clear positive development in the eyes of the market.

On the macro front, data reported in February has yet to reflect substantial improvement in the economy. HSBC manufacturing PMI has been on a downward trajectory, declining from 52.9 in January to 51.2 in February, after reaching a two-year high of 54.5 in December.

[1]Historical averages since 1996
[2]Bloomberg, as of 2/28/15

Industrial production slowed to a year-over-year rate of 1.7% in December, from 3.9% in November. Exports and imports contracted, declining 11.2% and 11.4%, respectively, year-over-year in January; however, this resulted in a trade deficit of $8.3 billion, India's lowest in 11 months. Though inflation ticked up to 5.11% in January from 5% in December, it remains below the central bank's upper target limit of 6%.

Investment Outlook

With inflation seemingly under control and domestic demand still subdued, the Reserve Bank of India (RBI) again cut interest rates by 25 basis points during an unscheduled meeting in early March. In addition to easing monetary policy, we believe corporations will also contribute to the effort to revive consumer activity by using input price benefits for trade promotions.

In visiting the region and meeting with policy makers over the last couple of months, we are seeing central government departments coordinating like never before, and believe steps being taken by the current government will strengthen the institutional framework of the economy and provide support for sustainable growth. For instance, reductions in the corporate tax rate and various tax incentives beginning in 2016 is a positive step towards reducing tax disputes and easing the policy framework. Risks remain in the form of the Modi government's ability to muster the opposition's support for key parliamentary legislation.

On a sector basis, we continue to prefer interest rate-sensitive sectors such as financials, industrials and autos. We remain less constructive on commodities, telecom and richly valued consumer staples.

Korea

Market Update

The KOSPI gradually recovered throughout February to end the month with a 1.87% gain, breaking through its 120-day moving average for the first time since September. The small/mid-cap-focused KOSDAQ continued to outperform, breaking through the upper limit of its box range (450-580) for the first time since the 2008 financial crisis. In terms of sectors, textiles, machinery, pharmaceuticals, and construction outperformed, while insurance, transportation and electronics lagged.

The Korean market was buoyed by positive global developments, including the European Union's extension of Greece's debt for an additional four months, as well as improved economic indicators across the eurozone and a halt to the depreciation of the euro against the US dollar. The global economy also benefited from stabilizing oil prices, which helped to ease concerns over deflation and Russian energy company bankruptcies.

On the local economic front, inflation continued on a downward trajectory, rising just 0.5% in February, from 0.8% in January and December. Exports continued to contract, decreasing 3.4% year-over-year in February, following a decline of 0.4% in January. Imports fell at an significantly faster pace of 19.6%, producing a monthly trade surplus of $7.66 billion, the country's highest on record. HSBC manufacturing PMI held steady at 51.1, while industrial production continued to improve year-over-year, growing 1.8% in January, up from 0.4% in December. At its February meeting, the central bank held interest rates steady at 2%, highlighting weak domestic confidence and demand.

Investment Outlook

In addition to the pace of the global economic recovery, the Korean market will be influenced by two primary external events going forward. First, the March Federal Open Market Committee (FOMC) in the US will better inform the timetable for interest rate increases, and second, China's National People's Congress (NPC) and the Chinese People's Political Consultative Conference (CPPCC) will address the country's GDP growth target and fiscal deficit.

In the US, while recent employment indicators have come in higher than consensus estimates, other factors, such as hourly wage growth, have yet to reflect meaningful improvement. Consequently, though sentiment toward the global recovery has improved in anticipation of rising US interest rates, we do not expect the Federal Reserve Board's dovish stance to change substantially at the March FOMC meeting. In China, upcoming government meetings are likely to focus on the country's growth rate and fiscal deficit, resulting in conservative economic decisions. We expect China to announce additional policies on both the monetary and fiscal fronts.

Domestically, the small/mid-cap market may experience a correction as concerns that the segment is overheating continue to grow. However, over the long term, strong IT software and biopharmaceutical stocks are likely to drive performance of this market.

The Association of Southeast Asian Nations (ASEAN)

Market Update

Market sentiment in the ASEAN region was generally positive during the month on the back of falling inflation and easing monetary policy. Malaysia was the biggest outperformer in the region as oil prices gained 18% in February, stemming concerns over the country's depreciating currency and deteriorating terms of trade. Despite depressed oil prices in recent months, the country registered stronger than expected growth in the fourth quarter, with GDP rising 5.8% year-over-year, up from 5.6% in the previous quarter.

The Indonesian market also outperformed the region as the central bank unexpectedly cut rates by 25 basis points to 7.5% following a sharp decline in inflation to 6.96% in January, from 8.36% in December. Although exports continued to decline (falling 8.09% year-over-year in January), imports contracted at a significantly faster pace of 15.59%, returning the country to a trade surplus of $710 million.

The Thai market was relatively flat in February after outperforming much of the region in January. The country dipped into deflation in January on falling oil prices, and other economic data reported during the month also continued to reflect subdued domestic demand. Despite current deflationary pressure and few signs of an economic resurgence, the central bank held interest rates steady at its February meeting, indicating that it believes price declines will be temporary and that inflation will pick up in the second half of the year.

The Philippines delivered a positive return but lagged a number of its ASEAN peers. Inflation continued to decline, but the pace was slower than expected. The CPI rose 2.4% year-over-year in January, slightly exceeding the consensus estimate of 2.3%. The Philippines central bank also held policy rates unchanged, citing decreasing inflationary pressure and solid growth.

Investment Outlook

We are cautious towards Indonesia as we expect volatility to remain high and private sector demand to remain weak. This puts the onus on policy makers to revive economic activity through public sector capital expenditure. With Jokowi, we believe a competent, uncorrupt leader has emerged to set the country on a more sustainable growth trajectory, as long as his nationalist stance doesn't scare off private sector investment. The outlook for Malaysia has brightened based on the stabilization of oil prices.

The Philippines seems to be on a growth path that is distinct from its regional peers, bolstered by its expanding business process outsourcing sector and growth of remittances from overseas workers, which hit an all-time high of $24.3 billion in 2014 and accounted for 8.5% of the country's total GDP for the year. The Philippines' impressive growth story risks being derailed if the government continues to postpone infrastructure and manufacturing development.

Across the region, we believe that momentum should improve in the coming quarters on the back of positive policy action and monetary easing. On a sector basis, we continue to like consumer discretionary, healthcare, technology and insurance.

Brazil/Latin America

Market Update

Brazil underperformed its regional peers in February but managed to break its negative momentum, with the MSCI Brazil Index returning 2.86% in USD terms for the month. The two key themes that continued to impact the market in February were a major oil producer's ongoing corruption scandal and the government's planned fiscal consolidation to bring the country back into surplus territory in 2015. In February, Moody's downgraded the major oil producer to non-investment grade, citing concerns over the corruption investigations, liquidity pressures that could result from delays in delivering audited financial statements, and the company's very high debt burden. Though this was widely expected to happen eventually, it occurred sooner than many anticipated. Meanwhile, the first signs of fiscal consolidation are beginning to emerge. While this is positive news for rating agencies and investors, it will hamper consumer spending and corporate profits in the near term.

The Latin American region overall gained in February, with the MSCI Latin America Index rising 4.22% in USD terms for the month, as the stabilization of energy markets gave investors confidence to commit new capital to the region. Mexico and Chile outperformed, while Colombia was the biggest underperformer. Mexico is showing early signs of improving economic momentum while Chile is benefiting from increased investor confidence.

Investment Outlook

Brazil's continuing focus on fiscal consolidation and President Rousseff's public support of the new finance minister appear to be showing positive effects on the fiscal balance. In the near term, however, tightening measures can be expected to have a negative impact on interest rates and growth in 2015. A primary oil supplier is also likely to remain in the news as repercussions of the investigation into its corruption scandal and its large debt burden impact current government and public finances. Meanwhile, rainfall levels remain disappointing, and with only two months left in the rainy season, the probability of water and electricity rationing continues to increase.

Given the current challenging economic backdrop, we have an increased preference for structural growth stories, including insurance, financial services and retail. Broadly, we favor companies offering above-average growth at attractive valuations, with a preference for high earnings visibility and proven cash flow generation potential. We have identified several value opportunities offering dividend and buyback support at current levels, notably within the financials, real estate and consumer sectors. We remain positive on export sectors as we expect the Brazilian real to depreciate in line with other emerging market currencies against the US dollar.

Across the Latin America region, we remain positive on Peru and are becoming more constructive on Mexico. We also hold a more optimistic outlook for Chile, which could gain on the prospect of stable or higher copper prices. We continue to be least constructive on Colombia. In terms of sectors, we are most favorable on financials and consumer sectors, and less so on utilities and energy.

Eastern Europe, Middle East and Africa (EEMEA)

Market Update

The Russian market corrected with the MSCI Russia Index gaining 22.82% in USD terms during February, as the stabilization of oil prices and a ceasefire with Ukraine helped improve investor sentiment. Though the currency continues to be volatile, it seems to have found a base as oil prices have stabilized. The market also took the ceasefire between Russia and Ukraine as very positive news since it reflected the first concrete sign that both sides now wish to move towards a more sustainable solution and are willing to cooperate.

Across the Eastern Europe region, Russia, Hungary and Greece outperformed, while Turkey underperformed. Politics were the main drivers of performance throughout the region during the month. Both Russia and Greece benefited from an improved political landscape, as Russia's ceasefire with Ukraine appears to be holding, while Greece managed to extend its bailout from the EU by four months. Hungary reported an end to its banking sector concerns and extended some taxation relief to the sector. On the other hand, Turkey was negatively impacted as the independence of its central bank was called into question after President Erdogan criticized it for not decreasing interest rates enough.

The Middle East/Africa region gained slightly in February as oil prices found a more natural level, benefiting Middle Eastern markets. South Africa, conversely, lost some momentum, as electricity rationing continued, placing a cap on the country's economic potential, and the 2015 budget featured an income tax increase, negating much of the positive impact from lower energy prices.

Investment Outlook

In Russia, the ruble is likely to remain highly correlated to the price of oil in the absence of any other major political news. Even though the ruble and oil prices have stabilized, we expect Russia to experience a significant economic contraction in 2015. Inflation is expected to peak at around 20%, and with wage growth unable to keep pace, consumer activity will be depressed, as sanctions imposed by the US and EU continue to weigh on the economy. Consequently, any reduction of the sanctions due to ongoing cooperation between Russia and Ukraine would be a positive catalyst for the Russian market. In the short term, we expect exporters to be the primary beneficiaries of the current environment.

Throughout the Eastern European region, we remain cautious on Russia and continue to focus on high-quality private companies where state interference is limited and owners' interests are aligned with shareholders. We are continually looking for opportunities that fit into our strategy as valuations remain attractive. Similarly, though Greece continues to face substantial near-term challenges, so far the market has not priced in very much improvement, leaving valuations at attractive levels, particularly if the country progresses towards a more sustainable solution to its debt burden. We remain positive on Turkey as we see it continuing to benefit from the European Central Bank's quantitative easing, as well as lower commodity prices, which should further reduce the current account deficit and support the currency. A truly independent central bank is critical for Turkey, and with elections scheduled for mid-year, headlines related to central bank independence and the country's political landscape should increase.

Within the Middle East/Africa region, South Africa should continue to benefit from relatively low energy prices but weaker growth and political issues, along with a strengthening US dollar, are putting downward pressure on the currency. This is likely to result in inflation thus requiring more cautious monetary policy. In contrast, our outlook for the Middle East is more optimistic given the stabilization in oil prices.