Market Commentary

December 2013

- **In the month of December, developed markets gained while emerging markets lagged.**
- **Indian equities enjoyed a strong rally in December, outperforming its emerging market peers.**
- **Valuations across global equity markets remain attractive relative to long-term historic averages.**

Global Emerging Markets

Global equity markets were mixed in the eventful month of December, when the US Federal Reserve announced that starting January 2014, it would start tapering its stimulus program by reducing asset purchases by $10 billion per month, to $75 billion. Developed markets gained while emerging markets lagged. The MSCI Emerging Markets Index closed down 1.4%, while the MSCI World Index and the S&P 500 Index rose 2.2% and 2.5%, respectively.

After a strong November, the MSCI China Index pulled back in December and fell 3.4% in US dollar terms, underperforming the broader emerging markets index. Sentiment towards Chinese equities turned more cautious as concerns about a liquidity crunch resurfaced, and economic data releases came in softer. HSBC manufacturing PMI came in at 50.5 in December, down from 50.8 the previous month. China's fixed-asset investment (FAI) trend declined in November, increasing just 19.9% year-over-year. However, trade data exceeded expectations as exports rose 12.7% year-over-year in November. The market is expected to continue to focus on China's economic rebalancing from an investment-led economy to a consumption-oriented one, and its impact not only on China, but on global growth.

Indian equities enjoyed a strong rally in December as the MSCI India Index closed up 3.1% in US dollar terms, outperforming the broader region. Although several macroeconomic indicators came in light, the market benefited from optimism surrounding the prospects for a pro-business government following India's upcoming general election. On the economic data front, HSBC manufacturing PMI fell to 50.7 in December from 51.3 the previous month. Inflationary pressure continues to persist as the Wholesale Price Index (WPI) increased to 7.5% in November from 7% in October. On a more positive note, India's currency continued to stabilize and its trade deficit continued to decline.

The MSCI Brazil Index ended the month down 4.6% in US dollar terms and registered a 15.8% decline for the year, one of the worst performances among major markets globally. Despite increasing signs of a recovery in global growth, sentiment towards the Brazilian market remains weak given the poor economic outlook. Brazil continues to suffer from a depreciating currency, negative revisions to growth and earnings estimates, and a deteriorating macroeconomic backdrop, including an expanding current account deficit and stubbornly high inflation. After experiencing numerous rate hikes in 2013, Brazil is likely to see further monetary tightening in the first quarter.

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 11.8x , whereas the MSCI World Index trades at 19.0x and the S&P 500 Index trades at 17.4x. Historically,[1] these indices have traded at 14.5x, 20.9x, and 19.3x, respectively.[2]

China

Market Update

Following a strong rally in November, the Chinese market experienced a mild correction in December as optimism over reforms announced during the Third Plenary session gave way to bank liquidity concerns, which led the central bank to inject nearly $50 billion into the banking system in order to avoid a repeat of last summer's cash crunch. Though down slightly, most economic indicators were within market expectations and reflected a stable economic trend. HSBC manufacturing PMI came in at 50.5 in December, down slightly from 50.8 in November, while industrial production was up 10% year-over-year in November, from 10.3% in October. On a positive note, exports exceeded expectations, rising 12.7% year-over-year in November, while imports grew a less-than-expected 5.3%, producing a monthly trade surplus of $33.8 billion, the largest since January 2009. Meanwhile, FAI data softened in November, increasing 19.9% year-over-year following five consecutive months of 20%+ growth.

On the policy front, more detailed reform plans emerged following the guidance presented during the Third Plenary meeting in November. The People's Bank of China moved one step forward in liberalizing interest rates by allowing the market to freely set the interbank negotiable certificate of deposit (NCD) rate. Additionally, the central government transferred more administrative approval rights to local governments, and encouraged more market-oriented coal transportation prices.

Investment Outlook

We maintain a positive outlook for China next year. Though sentiment is a bit lower following a strong rally and concerns over liquidity, the market remains cheap and China's economic situation is stable. On the policy front, we expect reforms to continue in 2014, which should provide more investment opportunities relative to 2013, and the government appears committed to using this period of global recovery to curb excessive credit growth through controls on wealth management products in the domestic economy.

In terms of sectors, we've become less constructive on liquefied natural gas-related energy as government support has been much weaker than previously expected, resulting in slower development than other city gas-related areas. On the other hand, we have a more positive outlook for mid-sized banks and insurance companies as government reform measures and related new regulations are expected to benefit financial companies operating in the private sector. Overall, we remain focused on fundamentals using a bottom-up approach to identify companies that are poised to benefit from reform, companies that are structurally changing, and those that are continuously gaining market share.

Long term, we are optimistic about China's ability to shift focus from investment-led growth to consumption-oriented growth as reforms announced during the Third Plenary session in November should improve prospects for the private sector while also correcting demographic and urban planning imbalances. However, in switching to new growth engines, performance among sectors could be very different than in the recent past. Energy and capital intensive industries, as well as high pollution industries, that are tied to FAI may be undervalued by the market, while consumer, healthcare, and environmental protection industries could continue to demand a premium.

India

Market Update

The MSCI India Index outperformed emerging markets overall on the back of a strong outlook for IT companies given the weak rupee and hopes of a pro-business government following the general election in April-May. Despite disappointing domestic growth, inflation and fiscal indicators, the opposition Bharatiya Janata Party's positive showing in state elections and the Reserve Bank of India's (RBI's) decision not to raise rates helped support market sentiment.

India also benefited from the positive backdrop in developed markets. Though the US Federal Reserve announced plans to begin tapering, the gradual nature of liquidity reduction and the fact that it represents stronger economic conditions in the US, allowed the rupee to remain relatively stable. On a sector basis, global sectors including IT services, energy, materials and healthcare outperformed, while local sectors such as financials, telecom, consumer discretionary and consumer staples underperformed.

On the local economic front, HSBC manufacturing PMI fell to 50.7 in December from 51.3 in November while the latest industrial production figure reflected a contraction of 1.8% in October. Though down from October's pace of 13.5%, exports grew 5.86% year-over-year in November, while imports contracted 16.37%, resulting in a monthly trade deficit of $9.22 billion, down from $10.56 billion in October.

[1]Historical averages from 1996
[2]Bloomberg, as of 12/31/13

Meanwhile, inflation continues to rise with the WPI accelerating to a 14-month high of 7.5% in November, from 7% in October, due to further increases in food prices. Despite persistent inflationary pressure, the central bank held the repo rate steady at 7.75% during its December meeting, surprising analysts who had expected an additional 25 basis point increase.

Investment Outlook

Since the summer when fears of US tapering first surfaced, India, which maintains a high current account deficit, has seen its currency and stock market fall. However, the RBI acted prudently by raising interest rates, and allowing currency depreciation to reduce its trade deficits. Consequently, the last six months have reflected significant improvement in India's monthly trade deficit, which has come down from around $18 billion at mid-year to a more manageable $10 billion level in recent months. As a result, the country is in a better position now that tapering has finally begun, especially since it is clear that the reduction in global liquidity will occur gradually.

Near term, much of the market's attention will be focused on India's upcoming national election. A victory by opposition candidate Narendra Modi would be a pro-business verdict and would help rekindle domestic investment and infrastructure growth and get the economy back on a growth trajectory. Persistent inflation also remains an immediate concern; however, food prices are expected to have eased in December, which would reduce pressure on the RBI to further increase rates. That said, new RBI Governor Raghuram Rajan has said that the central bank stands ready to act to control inflation if necessary.

Korea

Market Update

The KOSPI fell 1.4% in December as range-bound trading continued amid concerns over tapering of the quantitative easing (QE) program in the US, sluggish earnings, and export competitiveness as the Japanese yen continued to weaken. Foreign investors net sold, while institutional investors were net purchasers.

On a sector basis, utilities was the key outperforming sector following an electricity rate hike and plans to increase gas prices. Financials also outperformed on optimism of a potential recovery of cyclical earnings and higher market rates. On the other hand, underperforming sectors included healthcare, IT and consumer discretionary. Healthcare stocks continued to correct on demanding valuations, as well as slower-than-expected expansion into the overseas market. Meanwhile, the IT sector was negatively impacted when a major provider fell out of favor as investors priced in lower-than-expected earnings results.

On the local economic front, exports significantly surpassed expectations, rising 7.1% year-over-year in December, far exceeding the consensus estimate for 4.8% growth. Meanwhile, HSBC manufacturing PMI reached a seven-month high of 50.8.

Investment Outlook

Following the US Federal Reserve's announcement that it would begin tapering its asset purchases in January 2014, policy uncertainties have eased and expectations of interest rate hikes have been delayed. As a result, we believe volatility in developed markets will be relatively low. However, the Korean market may not benefit as much from the positive sentiment due to sluggish economic recovery and the potential negative impact of the won strengthening against the yen.

Also, despite positive global developments, concerns remain as the US and Europe have yet to record a significant rebound in export and import volumes. Additionally, China's shift towards economic rebalancing has lowered the nation's overall growth expectations, which could be detrimental to global economic growth. In terms of monetary policy, though the US is gradually heading to the exit of its QE program, the European Central Bank and Bank of Japan should maintain their expansive stance. Consequently, we do not anticipate sudden tightening in liquidity. That said, the US dollar will continue to appreciate against the yen, which may limit the upward trend of Korean exporters amid high expectations of a global recovery.

Domestically, potential 2014 downward earnings revisions following fourth quarter earnings results could also negatively impact sentiment. Currently, 2014 earnings growth estimates remain above the 20% level, despite the recent market correction; however, we view these estimates as high given the overly optimistic economic outlook. Additionally, recent currency strengthening and high valuations have limited foreign fund inflows, diminishing the upside potential for the Korean market.

Looking forward, on a sector basis, we remain focused on healthcare and media content from a long-term perspective as these two areas represent broad Asian trends. In addition, we are positive on stocks that are poised to benefit from increased Chinese consumption. Though macroeconomic conditions are crucial to earnings growth, we believe that over the long term earnings are determined by the core competitiveness of individual companies. Therefore, we remain focused on long-term earnings trends, rather than short-term earnings volatility.

The Association of Southeast Asian Nations (ASEAN)

Market Update

As the tapering by the US Federal Reserve was finally announced in December, the markets shifted their focus back to fundamentals and earnings, separating the performance of the ASEAN nations based on country-specific factors. For instance, while the Malaysian market reached an all-time high, Thailand continued to decline due to ongoing political issues.

The MSCI Indonesia Index fell slightly in December due to overall weak market activity as foreign investor outflows continued and a drop in the rupiah, which passed the 12,000 per US dollar mark, eroded gains. Meanwhile, inflation remained high, rising 8.38% year-over-year in December, on par with November's increase of 8.37%. On a sector basis, materials, consumer discretionary and consumer staples led, while utilities, energy and telecom lagged.

The Malaysian market reached an all-time high in December amid thin trading by foreign investors and the commencement of US tapering. However, inflation continues to inch up, rising 2.9% year-over-year in November, and the pressure will likely increase as the government recently announced a hike in the electricity tariff. Utilities and energy outperformed while healthcare underperformed.

Thailand was the worst performing market in the region as foreign investors net sold on concerns over the political stalemate that has continued since October. The MSCI Thailand Index fell 5.6% in December and is down nearly 24% from May 2013. Exporters, food and agriculture reflected strong performance in December given the improving outlook and baht depreciation, while domestic sectors like banks, property, and telecom underperformed. Inflation remained subdued, rising 1.67% year-over-year in December, down from 1.92% in November.

The Philippines lagged the region in December, falling 5.5%, with the market experiencing a significant sell-off during the first half of the month as tapering speculation pressured investor sentiment given the market's high valuation level. However, following the tragic typhoon in November, the government has approved a spate of infrastructure projects that reflects a combination of both reconstruction and modernization efforts. Meanwhile, GDP growth remains in excess of 7% and the country maintains a surplus of 4.6% of GDP; however, inflation rose to its highest level in two years, with the CPI increasing 4.1% year-over-year in December, up from 3.3% in November. Financials was the worst performing sector while utilities ended the month in positive territory.

Investment Outlook

Over the past decade, emerging markets performed as a homogenous pack. Moving forward, though we believe that markets will consolidate over the near term as economic growth softens following the second-half 2013 restocking and that the emerging markets discount to developed markets will narrow, growth and equity performance will be more differentiated across countries.

In Thailand, rising political tensions could be a drag on the economy for awhile; however, given the significant market correction in Thailand, valuations have again become attractive, and in light of its strong export orientation, we believe the Thai economy should improve over the next couple of quarters. Meanwhile, we remain cautious on Indonesia as we await further currency stabilization. However, we maintain a positive outlook for the Philippines, as rebuilding following last month's typhoon will continue to be a trigger for acceleration of infrastructure and consumer appetite remains strong.

Latin America/Brazil

Market Update

The MSCI Brazil Index fell 4.6% in December to end the year down 15.8% in US dollar terms. Brazilian equities have been among the weakest across both emerging and developed markets driven by currency depreciation, negative revisions to growth and earnings estimates, and a deteriorating macroeconomic backdrop, including an expanding current account deficit and stubbornly high inflation. Additionally, the dominance of large-cap energy and materials stocks in the index has contributed to underperformance; however, several export subsectors within the materials space, including steel and pulp, are now benefiting from the weaker currency.

For the month, healthcare stocks outperformed following the tender offer for a major medical testing firm by its largest individual shareholders. On the other hand, energy and financials led the underperformers. In addition, within the consumer sector, Christmas trading reports show mixed performance for Brazilian retailers, with several apparel chains continuing to struggle.

Across Latin America, equities declined 2.4% in US dollar terms. Brazil led losses while Peru was the biggest gainer due to its high exposure to mining stocks, which are benefiting from depreciating domestic currencies. Mexico also continued to outperform with reform tailwinds and its exposure to the US recovery supporting the positive investment outlook. On a sector basis, materials outperformed while energy led the underperformers.

Investment Outlook

The US Federal Reserve's recent tapering announcement points to further near-term headwinds for emerging market equities, with investment flows likely to remain skewed towards the US. However, because the decision reflects improvement in broad US economic fundamentals, global growth overall should continue to recover. Despite the continuing global economic recovery, sentiment towards Brazil remains weak due to inferior growth, high inflation and a weak currency.

Brazil is also likely to see further monetary tightening in the first quarter following the 275 basis points in rate hikes during 2013 while GDP growth is not expected to show any improvement, remaining at -2%. Exporters should continue to benefit from the depreciating real, which is approaching 2.40 against the US dollar; however, dollar-denominated investors are likely to remain on the sidelines until the currency stabilizes.

We maintain a selective view of the local equity market, continuing to prefer inflation-protected growth via toll roads, as well as structural growth stories including insurance and loyalty programs. Additionally, in the consumer staples and financial sectors we have identified several value opportunities offering dividend and buyback support at current levels. We also remain positive on asset-backed companies including malls and select consumer companies with brand equity and a robust growth outlook, including select footwear and food and beverage companies, and we are growing more constructive on local infrastructure and industrial sectors, as well as select exporters poised to benefit from further depreciation of the real in 2014. On the other hand, we maintain our negative stance on the energy sector following the lack of details provided in the recent fuel price policy announcement.

Throughout Latin America, sentiment is mixed. The growth outlook for the region is improving at the margin. Mexico has the most structural growth potential due to its prospects for material fiscal, energy and labor reform, though valuations have moved higher in anticipation of this growth. We also remain positive on Peru, but are less constructive on Brazil and Chile. In terms of sectors, we prefer industrials, including toll roads, capital goods, and transportation, but remain negative on the energy, telecom and utilities sectors.

Europe, The Middle East And Africa (EMEA)

Market Update

The MSCI Russia Index gained 1.6% in December, slightly outperforming emerging markets overall. The market benefited from President Putin's decision to pardon and release Russia's most prominent political prisoner, Mikhail Khodorkovsky, in addition to other political prisoners. While most investors believe he is simply trying to improve Russia's standing with the international community ahead of the Winter Olympics in February, there is increasing optimism that President Putin will take steps to improve the investment climate in the country.

Despite positive performance in Russia, Eastern Europe declined 2.7% in December to underperform emerging markets overall. Turkey was the primary contributor to the region's underperformance due to a growing political scandal that could threaten the prime minister's hold on power and fracture his ruling party. Certain companies have also been implicated in the scandal, while others have been targeted with higher taxes or government fines, further spooking investors. Poland, Greece, Hungary and the Czech Republic also sold off. On a sector basis, IT outperformed as a major Internet company continued its rally into year-end on optimism that 2014 would be a strong year.

The Middle East Africa region outperformed emerging markets overall. While South Africa largely tracked emerging markets given light volume and little corporate news, Egypt outperformed as news surfaced of an impending $5 billion financial aid package from Saudi Arabia.

Investment Outlook

Looking forward, in Russia, we continue to be most positive on consumer-oriented stocks, including the Internet, as the Russian consumer remains relatively healthy and there are a number of companies poised to benefit from the country's structural growth story. We have also grown more constructive on certain cheap cyclical stocks, such as steel companies that are now focused on cutting capital expenditures and increasing returns on invested capital and dividend payouts. However, we remain wary of natural resource companies and government-controlled entities that can be affected by adverse government policies and generate poor returns on invested capital.

Across the Eastern European region, we remain most positive on Russia while we have grown more negative on Turkey as the erupting corruption scandal makes the country even more vulnerable. We also continue to grow more constructive on Central Europe, particularly companies exposed to the rebound in domestic and European economic growth, such as high-quality and well-capitalized banks. On a sector basis, we like healthcare companies that are seeing an improved business climate and acceleration of earnings growth.

We are cautious on the Middle East Africa region as South Africa remains vulnerable given sluggish economic growth, high fiscal and current account deficits, the possibility of power outages, elevated risk of labor unrest, and generally fair to expensive equity valuations. Upcoming general elections could also lead to political unrest and possible populist policy measures. That said, we remain positive on select consumer names exposed to the upper end consumer and healthcare names that take advantage of increased healthcare spending.