Market Commentary

February 2014

- **Developed markets outperformed emerging markets in the month of February.**
- **Indian and Brazilian equities outperformed their emerging market peers.**
- **Valuations across global equity markets remain attractive relative to long-term historic averages.**

Emerging Markets

Global equity markets rebounded in February, with most indices closing in positive territory. Developed markets outperformed emerging markets as US stocks hit new record highs. The MSCI Emerging Markets Index rose 3.3%, while the MSCI World Index and the S&P 500 Index gained 5.1% and 4.6%, respectively.

The MSCI China Index closed up 2.6% in US dollar terms in February, underperforming the broader emerging markets index. Macroeconomic indicators were mixed. China's HSBC manufacturing PMI continued to decline, falling to a seven-month low of 48.5. Trade data, however, exceeded expectations as exports rose 10.6% year-over-year in January. The market was also impacted by the sudden weakness in China's currency, though this was understood as central bank intervention rather than a loss of confidence in the renminbi.

Indian equities outperformed the broader region as the MSCI India Index closed up 3.6% in US dollar terms. Market sentiment was boosted by continued stabilization of the rupee, as well as pre-election indications that the market favorite, Bharatiya Janata Party (BJP) led by Narendra Modi, continues to gain ground. Macroeconomic data was also supportive, as inflation came in lower than expected, and the trade deficit narrowed further.

The MSCI Brazil Index reversed its poor January performance and closed up 3.6% in US dollar terms, outperforming the MSCI Emerging Markets Index. The local currency held up relatively well despite a deteriorating fiscal balance and lower risk appetite. The central bank continued to tighten monetary policy by lifting the Selic another 25 basis points to 10.75%. Sentiment in Brazil continues to be bearish, and shaped by concerns surrounding the upcoming election later this year.

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 11.5x , whereas the MSCI World Index trades at 17.7x and the S&P 500 Index trades at 17.1x. Historically,[1] these indices have traded at 14.4x, 21.3x, and 19.2 x, respectively.[2]

[1]Historical averages from 1996
[2]Bloomberg, as of 2/28/14

China

Market Update

The Chinese market showed some recovery in February ending the month flat after corrections in December and January. While big names fell, presumably due to profit-taking, and concerns about a slowdown in the property sector added to market volatility, the IT, Macau gaming and environmental sectors continued to see valuations surge. The market was also impacted by central bank intervention designed to weaken the renminbi and moderate the influx of capital.

A number of macro indicators announced during the month met or exceeded market expectations. Exports and imports were much stronger than expected, with exports climbing 10.6% year-over-year in January, while imports were up 10%. Additionally, new loan growth hit a record high of $425 billion during the month. On the other hand, HSBC manufacturing PMI continued to decline, falling to a seven-month low of 48.5 in February; however, this was slightly better than the flash reading of 48.3.

Investment Outlook

Looking ahead, the market's attention should again turn to policy reform as the Chinese government kicks off the National People's Congress (NPC) on March 5. In his first work report, Premier Li Keqiang announced that the Chinese government is aiming for GDP growth of 7.5% in 2014 and meaningful progress on reforms. Though the growth target is likely based on higher exports given stronger growth in major developed markets, it also suggests that the government plans to proceed gradually in pushing forth structural adjustments and controlling local government debt. This year's forecast budget deficit of 2.1% of GDP is up slightly from 2013, while the money supply (M2) growth target remains unchanged at 13%, with the latter suggesting that overall credit growth may not slow as much as expected.

Reform plans extend to many areas of the economy. In terms of social reforms, the government plans to expand basic pension coverage to more people in urban and rural areas, raise the government contribution to the rural health insurance scheme, and expand serious disease coverage to more areas. Meanwhile on the tax reform front, it will apply value-added tax (VAT) reform to more businesses including railway, postal service, and telecom and expand resource tax reforms to the coal sector. Financial reforms include establishing a deposit insurance scheme, continuing with interest rate liberalization, allowing the establishment of private banks, expanding the exchange rate trading band, reforming the IPO system, and further developing the bond market.

In the near term, we remain cautious on the Chinese market, believing that it will continue to be range-bound due to continuing market uncertainty. We are also concerned that the government's 7.5% GDP target could be a bit too aggressive. However, we think that the gradual rollout of new reforms will be good for long-term economic growth. On a sector basis, the recent price correction has made energy, utilities and healthcare more attractive; however, we remain less constructive on financials due to the sector's strong connection to infrastructure and real estate investment. Additionally, we are more optimistic on consumption given its growth stability and fair valuation and see potential in segments poised to shape the business model in the new era, such as new energy vehicles, smart home appliances and industrial automation.

India

Market Update

The Indian market touched a new high in February as pre-election opinion polls indicate growing support for the market favorite, Bharatiya Janata Party (BJP), led by Narendra Modi. On the economic front, India's fourth-quarter GDP growth of 4.7% year-over-year was in line with expectations, but marked the seventh consecutive quarter of growth below 5%. Meanwhile, inflation was lower than consensus with the Consumer Price Index (CPI) coming in at 8.79% year-over-year in January, a 24-month low, as food prices moderated. Since becoming RBI Governor in September 2013, Raghuram Rajan has shifted focus from the Wholesale Price Index (WPI) to the CPI as the primary measure of inflation. In conjunction with the RBI's 25 basis point interest rate hike at the end of January, Rajan indicated that further rate increases were not expected if the inflation trajectory remained subdued.

Slightly higher export growth of 3.8% year-over-year, up from 3.49% in December, combined with significantly lower imports (down 18.07% year-over-year) to produce a smaller monthly trade deficit of $9.9 billion, down from $10.1 in the prior month, helped keep the currency stable. The slow pace of imports was largely due to a reduction in gold demand, implying that restrictions, including a higher import duty, are having an impact. Additionally, a successful telecom auction, which raised nearly $10 billion, further reduced pressure on the fiscal deficit. This follows two previous auctions, which were largely unsuccessful due to high floor prices. The telecom auctions in combination with the divestment of state-owned companies are an attempt by the government to reduce the budget deficit. On another positive note, HSBC manufacturing PMI for February came in at 52.5, up from 51.4 in January and the highest level in a year. HSBC services PMI also increased to 48.8 in February, from 48.3 in January.

Investment Outlook

In the near term, election uncertainty and the direction of inflation still pose risks, but stabilization of the rupee should continue to support sentiment. Looking out further into 2014, we believe Indian GDP has reached a trough and that a positive election verdict in mid-May would galvanize the investment cycle. The investment environment is also likely to be supported by a long-anticipated favorable monetary cycle of stable inflation, which should lead to interest rate cuts by the end of 2014.

On a sector basis, we are less constructive on strong performers in the IT and healthcare sectors, but more positive on private banks, which are trading at 10x 1-year forward earnings, the lower end of historical valuations. We also like industrials, like ports and toll roads, as these companies would benefit significantly from an economic uptick following nearly five years of underperformance. Beaten-down oil companies are also poised for a rebound given the government's strong resolve to reduce fuel subsidies. Additionally, domestic cyclicals could perform well on positive expectations for the upcoming election.

The Association of Southeast Asian Nations (ASEAN)

Market Update

Overall, the ASEAN region rebounded along with global markets. On a country basis, the Philippines and Indonesia outperformed the region. In Indonesia, better-than-expected macro data, slowing inflation, a stabilizing currency, and a gradually improving current account balance helped to lift investor sentiment.

On the economic front, fourth-quarter GDP growth figures released during the month reflected mixed results. Thailand's GDP grew only 0.6% year-over-year in the fourth quarter due to slowing consumer demand and political unrest, leading the country to reduce its annual growth projection for 2014 from 4-5% to 3-4%. Meanwhile, Malaysia's GDP grew 5.1% year-over-year, surpassing the consensus estimate for 4.8% growth, on the back of strong private sector demand and improving exports. Additionally, Indonesia surprised positively with fourth-quarter GDP growth of 5.7% due to resilient consumption even though interest rates rose 175 basis points between June and November. The Philippines, however, posted the highest growth rate in the region, with fourth-quarter GDP rising 6.5% year-over-year, despite the massive typhoon that hit the country in November.

Similar to growth, inflation in the region also continues to diverge. In Thailand, inflation remained stable at a subdued growth rate of 1.96% year-over-year in February, giving the central bank some flexibility to reduce rates at its March meeting. On the other hand, Malaysia's inflation continued to inch upward, rising to a 27-month high of 3.4% year-over-year in January, from 3.2% in December. Indonesia's inflation slowed more than expected, rising 7.75% year-over-year in February, trailing the consensus forecast for a 7.91% increase. On the other hand, inflation in the Philippines, though down slightly to 4.1% in February from a two-year high of 4.2% in January, reflects supply shocks following November's typhoon.

Investment Outlook

Overall, we believe the global recovery will continue, benefiting the ASEAN region over the coming year. However, the recent trend in volatility may also continue as short-term factors, such as the political tension in Ukraine, impact the market. Across the region, growth and equity performance will continue to diverge as country-specific factors have a greater influence on individual ASEAN economies. In Indonesia, upcoming presidential elections in summer 2014 will be a key event for the market, with recent polls indicating that Jakarta Governor Joko Widodo has gained a comfortable lead among likely presidential candidates.

On the other hand, the political situation is Thailand remains very fluid. Though the Pheu Thai party believes it won the election on February 2, official results have yet to be announced and protests and violence continue, prompting the government to start negotiations to resolve the deadlock. According to the Tourism Authority of Thailand, the country will lose THB90 million in tourism revenue if the political situation persists for another six months. In Malaysia, a smooth transition of government could allow infrastructure to proceed, while ongoing rebuilding in the Philippines should continue to serve as a growth catalyst.

Latin America/Brazil

Market Update

The Brazilian market gained in US dollar terms, with the MSCI Brazil Index rising 3.6% in February, but fell in local currency terms with the Bovespa declining 1.1%. That said, though weak, the currency held up relatively well in the face of a deteriorating fiscal balance and lower risk appetite, largely supported by the fixed-income market, where the 10.75% Selic rate continues to attract investors. On a sector

basis, industrials and financials outperformed. The financial sector has benefited from the rising rate environment, as well as high growth in segments such as insurance, merchant acquiring and collateralized lending. However, Brazilian banks still face the risk of punitive fines related to class-action lawsuits seeking compensation for depositors for insufficient interest rates paid to them in the late 1990s.

The MSCI Latin America Index also rose 1.9% during the month driven by Chilean equities, which benefited from an improvement in earnings momentum and sentiment as President Bachelet enters her second (non-consecutive) term. In terms of sectors, financials outperformed while telecoms underperformed due to a combination of profit-taking and equity raising overhang in Brazil, and regulatory threat in Mexico.

Investment Outlook

Sentiment in Brazil remains bearish as the prospect that the incumbent PT party will achieve re-election later this year leads to fears of another period of low growth, deteriorating external accounts and economic micro-management. As a result, any change in rhetoric from the current Rousseff government or a significant jump in support for opposition candidates could trigger a sharp market rally. Another potential headwind for the Brazilian economy is energy rationing. Because Brazil relies on hydropower for 80% of its energy matrix, low levels of rainfall have left several key reservoirs at near-record lows, increasing the risk of energy rationing, which would negatively impact industrial output and consumer activity.

We hold a selective view of the Brazilian equity market, with continued preference for structural growth stories, including insurance and loyalty programs. We have also identified several value opportunities offering dividend and buyback support at current levels, notably in the consumer staples and financials sectors, and we like asset-backed companies, including malls, as we believe yields are pricing in an unrealistic long-term rate of about 7%. We also remain positive on some local infrastructure and industrial sectors, as well as select exporters expected to benefit from further depreciation of the real. On the other hand, we maintain a negative stance on the energy sector following the disappointing fuel price policy announcement and concerns that a primary provider will remain under pressure to fund its growth pipeline in the near term.

Across Latin America, we have recently adopted a more balanced position given relative performance. We no longer find value in large parts of the Mexican market, though we remain structurally positive on the growth outlook for the country. In Brazil, our stance is marginally more constructive given valuations, though we remain cautious on the macro backdrop, and we are neutral on Colombia. On a sector basis, we remain positive on the financial and industrial sectors and less constructive on the energy, telecom and utilities sectors.

Eastern Europe, Middle East and Africa (EEMEA)

Market Update

The Russian market declined in February, with the MSCI Russia Index falling 6% for the month. While consumer staples posted a positive return, all other sectors sold off. In fact, the world's cheapest market has gotten even cheaper as the ruble has weakened and energy stocks have fallen amid escalating tensions in Ukraine. In early March, the currency and stock market dropped significantly as the Crimea region of Ukraine came under Russian control. This led the central bank to increase interest rates by 150 basis points in an effort to stabilize the currency.

The Eastern European region overall was driven down by the Russian market, where tensions in Ukraine have caused risk aversion to spike. In terms of sectors, energy led declines due to geopolitical risk, as well as speculation that a primary onshore drilling company could be purchased by a major customer.

In contrast, the Middle East Africa region gained 5.2% in February driven by financial, healthcare and consumer discretionary stocks, which more than offset weak performance from the consumer staples and telecom sectors. On a country basis, South Africa performed well, led by the consumer discretionary and healthcare sectors. A major gold mining company also delivered strong performance largely due to higher global volatility and risk aversion to emerging market equities since the start of the year.

Investment Outlook

In Russia, our strategy remains in investing in high-quality companies in industries generally left alone by the government, such as retail and the Internet. We're also growing more positive on certain cheap cyclicals and exporters, such as steel stocks, as these companies are beneficiaries of the weakening ruble. On the other hand, we remain wary of natural resource companies and government-controlled entities that can be affected by adverse government policy and generate poor returns on invested capital.

Across Eastern European, we remain positive on Russia, as well as Poland, which has the most favorable macroeconomic dynamics in the region. However, we continue to hold a negative stance on Turkey as the country suffers from a weakening currency, slowing economic growth, high inflation and political instability.

We remain cautious on the Middle East Africa region. South Africa remains vulnerable given its sluggish economic growth, high fiscal and current account deficits, the possibility of power outages, elevated risk of labor unrest, and high consumer indebtedness. The upcoming general election could also lead to political unrest and the possibility of populist policy measures. On a sector basis, we favor select consumer and healthcare names that are not interest rate sensitive and benefit from structural growth stories, as well as companies that derive the majority of their earnings abroad. Meanwhile, we continue to avoid unsecured lenders, companies highly exposed to the rand, and interest rate-sensitive consumer companies.