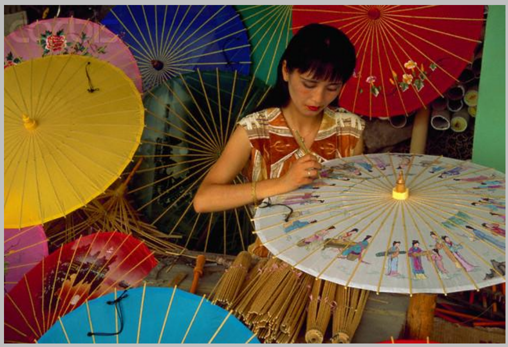
October 2010
Review of Emerging Markets



Focus Asia-Pacific

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Highlights of the month

- As had been the case in September, both developed and emerging markets continued to gain ground during October
- Investors' appetite for risk continued to improve. The latest round of economic statistics from the USA and Europe indicated that economies are growing in absolute terms and/or in relation to prior expectations
- The indication from the US Federal Open Market Committee (FOMC) that it is contemplating another round of Quantitative Easing (QE II) is a key reason for the improvement in general optimism. However, QE II is consistent with a weaker US Dollar, which continued to fall relative to most other currencies during October
- Commentators were favourably surprised by the decision of the People's Bank of China to lift interest rates. In addition, Xi Jinping's appointment as Vice-Chairman of the Central Military Commission of the Chinese Communist Party was widely seen as a positive development
- In various emerging markets, governments or central banks indicated that they are concerned about the impact on activity of rising currencies. Some central banks took steps to limit speculative inflows
- In general, the newsflow was consistent with superior economic growth in the emerging markets and/or favourable reassessments of risk

Statistical summary

Stock market Indices	1 month	3 months	6 months	12 months
Emerging Markets	2.81%	11.53%	8.40%	20.95%
Eastern Europe	4.54%	8.87%	0.57%	11.64%
Russia	4.93%	6.79%	-0.32%	11.55%
Arabian Markets (Ex Saudi)	2.47%	12.84%	2.42%	3.28%
Latin America	3.05%	10.93%	9.12%	20.70%
Brazil	1.24%	7.79%	4.30%	12.09%
Asia Pacific Ex Japan	2.65%	12.17%	7.26%	16.96%
China	3.89%	9.62%	7.92%	8.68%
India	1.48%	16.05%	11.38%	33.22%

Sources: Bloomberg/MSCI/Barra as at1st November 10

Global emerging markets in October

The rally in global equities, which began in September, continued in October. Market participants continued to take the view that a second round of Quantitative Easing (QEII) by the US Federal Reserve would prevent both the US and the global economy from slipping back into a 'double dip' recession. In the 'core' countries of the Euro area, but also in the UK and – to a lesser extent – the USA, statistics pointed to further improvements in economic activity (whether in absolute terms or in relation to prior expectations.)

This was good news for the emerging markets. In most cases, the latest economic data indicated that growth is being boosted by exports and/or robust domestic demand. A partial exception to this was Central and Eastern Europe. Indermit Gill, the World Bank's Chief Economist for that region, noted that - except in Turkey - employment had not recovered as rapidly as output. An additional challenge facing policymakers in much of Central and Eastern Europe is that growth has been supported by exports to a limited number of (admittedly large) markets in Western Europe, such as Germany. However, the rise in the Euro (to which many of the currencies in Central and Eastern Europe are linked) relative to the US Dollar over recent months may make it harder for exporters – both in the region and in Western Europe – to sustain growth over the medium term.

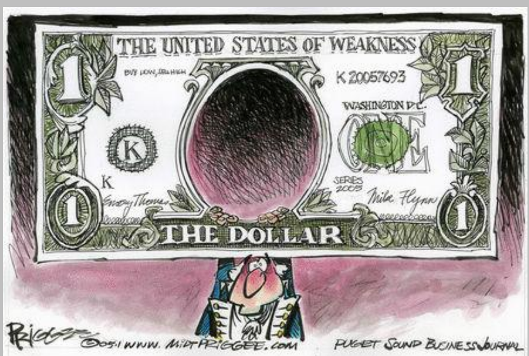
Nevertheless, as the figures on the table on the front page of this Review show, investors' appetite for risk remained healthy. Along with their counterparts in the Middle East (outside Saudi Arabia), the Central and Eastern European markets were among the best performing of any markets during October, whether developed or emerging. By contrast, in a month where most developed markets gained by 3-4% in US Dollar terms, particular larger emerging markets – such as India and Brazil could almost be described as laggards.

One key theme during the month was the continuing move by central banks in emerging markets countries to lift official interest rates towards normal levels. Policy-makers are focusing on the challenges of growth and inflation, rather than on the problems of deflation and unemployment.

Specific examples relating to the Asia-Pacific are given in the monthly Region in Focus article below. However, it remains correct to say that emerging markets generally are generating much of the growth of the global economy. In the third week of October, South Africa's Finance Minister Pravin Gordhan signalled that that country's government is lifting its growth forecasts. A World Bank report that was released during the month highlighted the resilience of the Latin American countries in the wake of the global financial crisis and their demonstrated ability to grow through trade with the Asia-Pacific.

The World Bank is looking for the Latin American and Caribbean region as a whole to grow by 5-6% this year and by at least 4% next year. The World Bank foresees that Argentina, Brazil and Peru could achieve rises in GDP of around 7.5% over the course of 2010.

Another theme which persisted during the month was the general weakness of the US Dollar. It fell by more than 3% against the Japanese Yen over the course of October, reaching a 15-year low versus that currency. It also slipped by 1-2% relative to other major currencies. The general weakness of the US Dollar, and capital inflows to emerging markets, have caused some governments and central banks to take steps to discourage speculative inflows. Over the recent past, the authorities in Brazil have doubled the tax that is payable by foreign investors who buy government bonds in that country.



Region in focus: Asia Pacific

During the month of October, virtually all of the trends and themes that were observable in emerging markets generally were present in the Asia-Pacific.

A key development in the middle of the month was the decision of the People's Bank of China to increase the one-year lending rate from 5.31% to 5.56%. The one-year deposit rate was increased from 2.25% to 2.50%. Many observers were surprised by this policy decision, but welcomed it – as they had previously perceived the Chinese economy to be at risk of overheating.

Nevertheless, the recent initiatives by various city governments in China to limit the ability of individuals to buy houses suggests that the central bank's main objective may be to prevent a speculative bubble in housing prices.

Another highlight of October was the appointment of Vice-President Xi Jinping as Vice-Chairman of the Central Military Commission of the Chinese Communist Party (CCP). The significance of the appointment is that Xi's ultimate succession of Hu Jintao as General Secretary of the CCP in 2012 is more likely. Xi's reputation as an effective operator who favours increased engagement with the West means that his ascent to the most powerful position in the Chinese government – which is not a certain outcome – would likely be well regarded in global financial markets.

In mid-October, two of the region’s central banks confronted policy dilemmas which, in essence, are the result of economic strength and success.

The Policy Board of the Bank of Korea left its key official rate unchanged at 2.25% for the third consecutive month. This was in spite of consumer price inflation in South Korea rising to near the top of the 2-4% target band of the central bank. The Bank of Korea is concerned by the appreciation of the Won – by around 8% - vis-à-vis the US Dollar over the last three months or so: it feared that a tightening of monetary policy might lead to a further rise in the currency that could have an adverse impact on South Korea’s exporters.

Later in the month, South Korea’s Finance Minister indicated that the government is contemplating measures – the details of which were not specified – to counter the strength of the Won. Elsewhere, the Monetary Authority of Singapore (MAS) announced that it would allow a faster appreciation of the Singapore Dollar as a measure to curb inflation, which had risen to an 18-month high of 3.3% in August.

Unlike other central banks, the MAS targets particular levels of the Singapore Dollar against a basket of currencies, rather than interest rates. The challenge for that central bank is that the country’s GDP contracted sharply in 3Q10, after having grown very strongly in the three months to the end of June.

Meanwhile, official statistics in India showed that year-on-year food price inflation in that country had slowed from 16.37% to 15.53%, thanks in part to good monsoons and a favourable harvest of grain. The data will likely be seen by the Reserve Bank of India as being positive, given that the central bank has been concerned to limit inflationary pressures. As is the case with South Korea and Singapore (as well as Brazil), a rising currency is regarded by the Indian authorities as a policy challenge. Since the beginning of 2010, inward foreign portfolio investment into India has risen to a record US$33.8bn, which has boosted both the stock market and the Rupee.

The latest developments in South Korea, India and China are consistent with cyclical growth. In each case, the authorities are dealing with the implications of economic growth, inflationary pressures and appreciating currencies. What is sometimes forgotten is that the Asia-Pacific is also home to secular, longterm, growth in the populous countries of Southeast Asia.

Collectively, the ten member states of the Association of South East Asian Nations (ASEAN) have a population of 580 million (of whom about one half live in Indonesia). By this measure, they are considerably larger than the USA or the European Union, although smaller than China or India. Nevertheless, they can claim to be too large to ignore. On their own, the populations of Thailand (64mn), Vietnam (87mn), and the Philippines (90mn) are substantial.

A major part of the investment case for the ASEAN countries revolves around the fact that their populations are young, growing and likely to become richer. According to regional stockbrokers CLSA, discretionary spending by households in India and

China is likely to grow at double-digit rates in India and China annually through the five years to the end of 2014.

The same is true of Indonesia. Discretionary spending is likely to increase by around 7% annually through that period in Thailand and the Philippines.

This, in turn, means that consumerism across the region is a key theme, perhaps even in world terms. Well over 1.1mn new vehicles were sold in the ASEAN countries during 1H10. That represents a 41% increase over 1H09, and indicates that the regional car industry is on track to surpass the record of 2.09mn cars that were sold in 2008. Data compiled by Morgan Stanley suggests that, over the six years to 2014, the number of passengers carried by low-cost airlines in the region should rise by 6.3% annually, as the overall population rises by 0.9% each year.

Another key theme is that the ASEAN countries collectively are very well placed to benefit, as suppliers of raw materials, from the growth of the world economy in general and of China in particular. Vietnam and Thailand together account for over half of global exports of rice. Malaysia and Indonesia speak for nearly 90% of the world's exports of palm oil. Thailand, Vietnam and Indonesia supply over one third of the shrimp that is traded internationally. Indonesia alone provides well over one quarter of the globally traded thermal coal for use in power stations. No less than nine-tenths of the world's rubber exports come from the ASEAN countries.

Palm oil: 90% of world export of which is from Malaysia and Indonesia

In part because of the impact of the Asian financial crises of 1997-98, the regional banking systems are well capitalised and under-developed. In wealthy Singapore and relatively wealthy Malaysia, bank credit amounts to about 100% of GDP, which is broadly in line with the situation in China or many developed countries.

Elsewhere in the ASEAN countries, bank lending is much smaller relative to overall economic activity. The crucial point is that, across the region as a whole, consumption and investment can grow at a faster rate than incomes. This is because households and businesses have the scope to borrow more; banks, to lend more.

Finally, we note that there are opportunities from ‘frontier’ economies in – or near - the region: Vietnam and Sri Lanka. Vietnam is enjoying a surge in foreign direct investment, which should promote the urbanisation and modernisation of the country. Following the cessation of the 20-year civil war in Sri Lanka, reconstruction is underway: we are particularly optimistic about the potential regeneration of the tourism industry.

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