



November 2010 Review of Emerging Markets



Focus Middle East and North Africa

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Highlights of the month

- Risk assets, including emerging markets equities, were sold down in November
- Investors unsettled by the financial problems of the Irish government and, later in the month, hostilities between North Korea and South Korea
- These issues overshadowed economic data, from both developed and emerging markets, which was generally favourable
- Various emerging market central banks, including the People's Bank of China and the Bank of Korea, tightened monetary policy during the month, and/or indicated concerns about potential inflows of 'hot' money
- In Hong Kong, the authorities increased stamp duties on residential real estate transactions, in order to curb speculation
- Brazilian President-elect Dilma Rousseff announced her economics team. There were no surprises. Guido Mantega remains Finance Minister

Statistical summary as at 30th November

Stock market Indices	1 month	3 months	6 months	12 months
Emerging Markets	-2.70%	10.91%	16.13%	12.88%
Eastern Europe	-3.36%	9.46%	12.30%	4.47%
Russia	-0.08%	10.98%	13.60%	8.93%
Arabian Markets (Ex Saudi)	-1.80%	8.55%	11.55%	7.44%
Latin America	-3.58%	9.67%	15.55%	7.44%
Brazil	-4.93%	6.29%	11.28%	-1.47%
Asia Pacific Ex Japan	-2.20%	12.00%	18.01%	11.52%
China	-2.39%	10.04%	18.01%	11.52%
India	-6.56%	10.15%	13.33%	14.86%

Sources: Bloomberg/MSCI/Barra as at 1st December 10

Global emerging markets in November

November was not a good month for risk assets. Both developed and emerging markets equities lost ground during the month as did emerging market debt. Unlike in October, the US Dollar rose against most other currencies, as it was seen as something of a 'safe haven'. Investors were unsettled by the financial problems of the Irish government and, towards the end of the month, the resumption of armed hostilities between North Korea and South Korea.

These issues overshadowed three other trends which were evident during the month. First, economic growth in the recent past has generally been quite firm in the US, the UK and 'core' European countries such as France and Germany. This was the case even as the US Federal Open Market Committee embarked on the second round of Quantitative Easing (QE2) in early November. Second, demand remains strong in most emerging markets. Third, mounting inflationary pressures (and/or other issues) caused several emerging markets central banks to tighten monetary policy.

In late November, the People's Bank of China, for instance, announced that the Reserve Deposit Ratio (the percentage of deposits that must be held by the commercial banks and not lent on) would increase by 0.5% to 18.5%. This is the fifth such rise this year, and takes the Ratio to the highest level ever.

China's central bank is keen to curb lending by the banks and is concerned about inflationary pressures. The latest official statistics show that consumer prices in that country rose by 4.4% year-on-year in October.

Meanwhile, the Hong Kong Monetary Authority (HKMA), the de facto central bank of the Special Administrative Region, mandated that stamp duty on residential property transactions be increased significantly. The HKMA is keen to curb speculation in Hong Kong's real estate market, given that prices have risen by around 50% since the end of 2008. The increase in prices has been fuelled in part by investors from mainland China.

Separately, the Bank of Korea noted that an index of consumer confidence in South Korea had rebounded in November, having reached a 16-month low in October.

Earlier, the central bank had announced an increase in its benchmark interest rate by 0.25% to 2.5%: this was the second rise this year. During November, the South Korean Finance Ministry announced that it would reintroduce a withholding tax on foreign investors' income from government bonds in order to discourage inflows of 'hot money' seeking higher interest rates than those that are available in most developed countries and/or profit from currency appreciation.

As indicated above, the latest round of quarterly economic data (i.e. pertaining to 3Q10) was generally favourable.

Output in Thailand, for instance, rose by 6.7% year-on-year, although this was less than had been expected. In South Africa, annualised growth in 3Q10 was 2.6%, or marginally less than the (revised) 2.8% of 2Q10.

Official data in Mexico suggested that that country had achieved 5.3% growth year-on-year in 3Q10. This was in spite of weakness in the construction sector, which only expanded by 0.9%. The implication is that recent strong growth in Mexico's export sector is feeding through to consumption.

In Brazil, President-elect Dilma Rousseff announced her economics team, the composition of which was in line with expectations.

Guido Mantega remains Finance Minister. Alexandre Tombini will replace Henrique Meirelles as President of the Banco Central do Brasil (BCB). Miriam Belchior will lead the Planning Ministry. The re-appointed Finance Minister confirmed that the government is determined to fight inflation and to reduce current expenditures. Incoming central bank President Tombini confirmed that the BCB's operational autonomy continues to be guaranteed.

Region in focus: Middle East & North Africa

The case for emerging markets investment usually revolves around three propositions. One is that emerging markets can sustain superior rates of economic growth over the long term and, as a result, corporate earnings should grow more rapidly.

The second is that emerging markets asset values should be rerated upwards as a result of positive economic policies that are consistent with lower levels of perceived risk. The third is that financial liberalisation in emerging markets helps mobilise savings and reduces the cost of capital. All three propositions are consistent with rising share prices, provided that everything else is equal.

Often, one of the three themes is dominant. For much of the last two decades, economic growth, as a result of trade-focused industrialisation, has been the main story in the emerging markets of the Asia-Pacific region (even though the details have varied from country to country). Conversely, the principal theme in Central and Eastern Europe (until 2008, anyway) was the reduction in risk as economies and financial systems became integrated with those of Western Europe. A reduction in the cost of capital has been a major driver of financial markets (and much else) in Brazil (and some other parts of Latin America) over the last decade.

One of the reasons why the diverse emerging markets of the Middle East & North Africa (MENA) region appeal is that all three themes are clearly present. Some countries, being among the world's largest (and lowest cost) producers of oil and gas, are clearly exposed to the growth in the world economy.

Other countries, such as Turkey and Egypt, are benefiting from widespread perceptions that risk levels are falling. In several of the Gulf Co-operation Council (GCC) countries – such as the United Arab Emirates (UAE), Qatar and Bahrain – governments are clearly promoting the development of financial services as a part of policies to reduce economic dependence on hydrocarbons: this is a good example of financial liberalisation.

Across the MENA region as a whole, there are a number of positive investment themes. One is demographics. Most MENA countries have populations that are young and fairly rapidly growing. It is sometimes forgotten that the region is home to a lot of people.

The two most populous countries – Egypt and Turkey – alone have a combined population that is about half that of the US and roughly one third that of the European Union. In part because of policies of economic diversification, investment in infrastructure is, and will continue to be, huge. As is not the case in most developed countries, governments and households are generally unencumbered by debt.

With this background, the Baring MENA Fund, for instance, is well diversified in terms of geographic exposure. At the end of October 2010, Egypt and the UAE each accounted for about 20% of net assets. The next three largest exposures were Kuwait (15%), Turkey (12%) and Qatar (11%). A further 7% of the fund was invested in Saudi Arabia; 5%, in Oman.

No less than 46% of net assets was invested in financial stocks. A major holding is Egypt's Commercial International Bank (CIB). Baring's believe that there is huge scope for growth in CIB's business over the medium-to-long term. This is partly because of Egypt's comparatively young population. It is also because there are large numbers of Egyptians who do not yet have bank accounts, let alone credit cards or mortgage loans. In addition, CIB's financial position is very strong: its Loan-to-Deposit Ratio, for instance, is less than 60%. We also like EFG-Hermes, which provides brokerage, asset management, private equity and investment banking services across the region. As regional financial markets continue to recover from the impact of the global economic downturn, EFG-Hermes is well placed to benefit.

Like CIB, it has a strong balance sheet. Under its experienced and dynamic management team, it is well placed to expand into new locations by way of mergers and acquisitions.

Several of the companies that the Baring MENA Fund holds are clear beneficiaries of the region's infrastructure boom. Depa, for instance, is a UAE-based company that specialises in the fit-out and furnishing of private and public facilities across MENA and Southeast Asia. It works on hotels, yachts and apartments, as well as hospitals, airports and shopping malls. Because the firm operates in the later stages of the construction process, it is reasonably well protected from cancellations and defaults. Depa has a strong balance sheet and a large book of forward orders.

It is well placed to benefit from large-scale infrastructure projects and hotel refurbishments, in Abu Dhabi, Saudi Arabia and further afield.

We are also impressed with the growth prospects of Drake & Scull, which provides electrical and mechanical engineering solutions. The firm has continued to perform well, in spite of the well-publicised problems of the construction sector in Dubai, where it is based. Like Depa, Drake & Scull has a large order book and exposure to growth markets throughout the GCC region (such as Kuwait and Qatar).

Hikma Pharmaceuticals, by contrast, is one of the Fund's larger holdings that should benefit from rising household incomes (and growing populations) in Egypt and other less developed countries across the region. Hikma develops and manufacture generic and in-license drugs. Importantly, Hikma has approval rom the US Food and Drug Administration (FDA) for its facilities across the MENA region – which means that it can export to the US and Europe. Nevertheless, its business within MENA should grow strongly over the medium-term.

In summary, we continue to believe that the investment case for MENA is compelling. The region offers an attractive combination of positive structural change and long-term economic growth. At the company level, there are a number of opportunities whose current valuations do not, in our view, adequately reflect their long-term potential.

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