

Review of Emerging Markets

October 2010

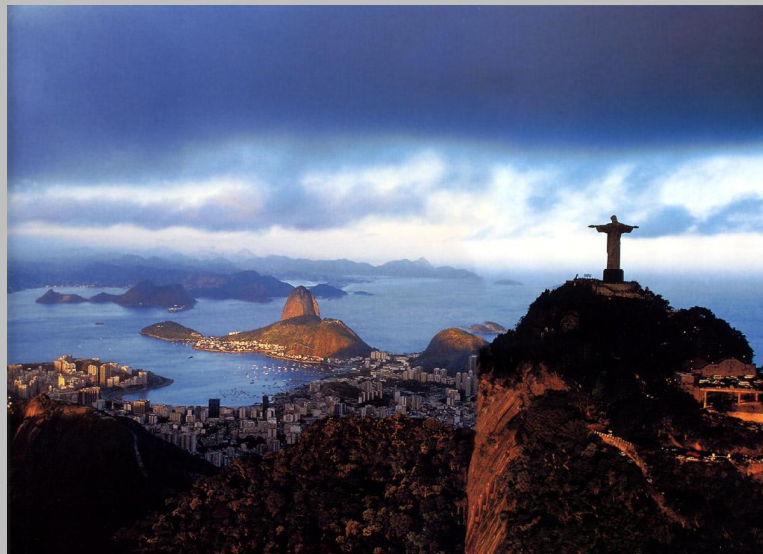
Focus - Brazil

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Highlights of the month

- Virtually all emerging markets performed well during September. Globally, investors' appetite for risk improved substantially
- The main catalyst for the change in sentiment was the indication from the US Federal Open Market Committee (FOMC) that it is contemplating a new round of Quantitative Easing (QE II). Together with improved economic data from the US, this was taken to mean that the risk of a 'double dip' recession is much lower
- The prospects of QE II caused the US Dollar to weaken relative to virtually all other currencies. In the emerging markets, the currencies of Central and Eastern Europe were notable for their strength
- Emerging market central banks continued to lift official interest rates towards 'normal' levels. During the month, the Reserve Bank of India, for instance, tightened policy
- Statistics pointed to a re-acceleration of growth in China and continuing strong growth in Southeast Asia
- Investors' perceptions of risk in Latin America continued to improve

Statistical summary

Stock market Indices	1 month	3 months	6 months	12 months
Emerging Markets	10.87%	17.16%	6.45%	17.67%
Eastern Europe	8.34%	17.37%	-4.45%	11.12%
Russia	5.85%	13.09%	-5.74%	11.08%
Arabian Markets (Ex Saudi)	8.69%	17.32%	1.90%	-1.60%
Latin America	10.37%	20.39%	5.06%	18.77%
Brazil	10.43%	21.04%	1.64%	13.38%
Asia Pacific Ex Japan	11.57%	17.01%	5.72%	13.49%
China	8.51%	10.10%	3.27%	11.32%
India	16.16%	15.04%	11.75%	25.85%

Sources: Bloomberg/MSCI/Barra as at 30 September 2010

Global emerging markets in September

Like developed markets, emerging markets performed very well during September. Investors came to the conclusion that neither the US nor the global economies are going to fall back into a 'double dip' recession – which had been a significant concern during August.

The change in perception was driven in part by more positive statistics from the US labour market. More importantly, the US FOMC indicated that it is contemplating a new round of Quantitative Easing (QE II) in coming months.

The prospects of QE II caused the US Dollar to weaken during the month against virtually all other currencies. It fell sharply against most currencies in Central and Eastern Europe (and the Euro). Investors focused on the hawkish comments made by several central banks in that region.

In late September, Chinese Premier Wen Jiabao attempted to address criticism that the Renminbi is – in spite of its recent appreciation – undervalued vis-à-vis the US Dollar.

The Premier suggested that the level of the Chinese currency is not causing the US trade deficit with China, or fuelling US unemployment. He also warned that a 20% rise in the Renminbi relative to the US Dollar would cause severe job losses in China and exacerbate social instability.



Chinese Premier Wen Jiabao

The Premier's comments followed comments from US President Barack Obama, which suggested that the (unreasonably low) level of the Renminbi gave China an unfair advantage in global trade. Towards the end of September, the US House of Representatives voted 348-79 for a measure that would let domestic companies petition for duties on competing imports from China, in order to compensate them for the effect of a weak Chinese currency.

Elsewhere, the Thai Baht rose to 13-year highs during the month, thanks in part to the rapid expansion of exports, which were nearly 25% higher in August than they had been in the same month of 2009. Brazil's central bank intervened in currency markets to limit the appreciation of the Real.

Data released in China during the month showed that exports and domestic consumption are rising strongly. Inflation is edging up at an appropriate pace and bank lending is moderating, as intended by policy-makers. Industrial production increased annually by a higher-than-expected 13.9% in August. This compared with a 13.4% rise in July.

Retail sales also expanded faster than forecast, rising by 18.4% year-on-year, up from 17.9% in July. Fixed-asset investment rose 24.8% in the first eight months of the year compared with the same period of the previous year. New bank loans reached Rmb545.2bn during August and the annual rate of growth of M2, the broadest measure of money supply, increased to 19.2% from 17.6%.

Chinese imports in August rose 35.2% from the previous year, above expectations and better than the 22.7% rise in July - helping narrow the country's trade surplus. Inflation in the month rose to 3.5% from 3.3% the previous month.

Speaking at a meeting of the World Economic Forum, Premier Wen Jiabao called on China's local governments to take part in the drive to discourage property speculation and said that limiting house price increases was central to maintaining social stability.

Meanwhile, the Reserve Bank of India said that it was moving closer to a neutral monetary policy by raising its repo rate – at which the central bank lends to commercial banks – by 0.25% to 6%. India's central bank increased the reverse repo rate by 0.5% to 5%. The rate rise was the fifth this year and follows growing demand for the nation's goods (given that overseas shipments in August rose 22.5% from a year earlier) and mounting inflationary pressures.

The Reserve Bank of India is one of many emerging market central banks that have been lifting official interest rates to 'normal' levels (i.e. from the unusually low levels that applied in the wake of the global financial crisis) over the last year or so. In this respect, the emerging market central banks as a group differ from their counterparts in the major developed countries, where official interest rates remain at very low levels.



Region in focus: Latin America

As the year has progressed, Latin American stock markets have delivered good returns, as we have expected. Perhaps more than emerging markets in other parts of the world, the Latin American markets are benefiting from a steady improvement in investors' views of them. In essence, the perceived levels of risk attached to Latin American assets is going down.



Traditionally, the risks associated with the Latin American markets have been derived from three sources.

First, particular governments have pursued policies that are fiscally unsustainable or hostile to the interests of foreign investors. Arguably this is true of President Hugo Chávez's administration in Venezuela even today.

Second, the fortunes of economies in the region have been perceived – rightly or wrongly – to be determined by trends in prices of mineral and agricultural commodities, of which many Latin American countries are substantial producers.

Third, the region suffered from a lack of savings: through the 1990s (and, perhaps, as recently as the last Argentine financial crisis of 2001-02) there had been unsupportable current account deficits, debt defaults and devaluations of currencies. We contend that, for all the major economies in the region, these problems are now in the past.

According to Morgan Stanley Research, levels of public sector debt are low in Latin America by the standards of other emerging markets. They are even lower by the standards of developed countries, where governments are borrowing more in order to deal with the aftermath of the global financial crisis of two years ago.

Furthermore, Latin American households and businesses are under-g geared.

According to the World Bank, total credit to the private sector in 2008 amounted to around 30% of Gross Domestic Product (GDP) in Mexico, and about 60% of GDP in Brazil. In South Korea and China, the corresponding figures were around 100%; in South Africa, over 130%.

The common characterisation of Latin American economies as commodity exporters is, broadly speaking, correct.

Nevertheless, our sources – the World Bank, the central banks and statistics institutes of particular countries and Morgan Stanley Research – indicate that the reality is more complex.

Revenues from (overwhelmingly mineral) commodities account for over 80% of export revenues of Chile, Peru and Venezuela.

At the other extreme, commodities account for about 60% of the export revenues of Brazil and a little over one quarter in Mexico.

Mexico's close economic linkages with the US mean that manufactured goods are the dominant part of its export mix.

Commodities account for about two-thirds of the export revenues of Argentina and Colombia. In some countries, minerals and energy companies are far more important in terms of their stock market capitalisation than they are in terms of their contribution to the overall economy.

However, some economies in the region are a lot more open than others. In Chile, where policy-makers have for a long time emphasised export-led development and growth (like their counterparts in virtually all countries in East and Southeast Asia), exports amounted to over 40% of overall GDP in 2009.

For all the excitement – mostly justified – about Brazil as one of the most important emerging markets investment opportunities over the coming decade(s), its economy is fairly closed. Exports last year amounted to about 12% of GDP.

For Mexico and Peru, the corresponding figures were 25-30%; for Argentina, Colombia and Venezuela, around 18-23%.

Brazil is also a natural beneficiary of the resource-intensive growth of China and other developing countries. This is partly because of its global importance as a supplier of minerals such as iron ore. However, it is also because Brazil is a low cost supplier of materials.

Ethanol, for instance, can be produced in the Euro area at a cost of US\$0.70/litre or in the United States at a cost of US\$0.34/litre.



Brazil's Ethanol Industry

In Brazil, by contrast, production costs are US\$0.22/litre. The cost of producing sugar in Brazil is US\$0.09/ pound, or about one third of the cost of producing in the Euro area. A recovery in domestic demand is also central to the prospects for Mexico. Consumer confidence, which fell sharply in 2008 and which reached a trough last year, has started to recover.

Industrial confidence, which is a leading indicator of investment, has soared over the last year and is now very close to the highs last achieved in 2007. As a result, employment is surging. In the wake of the global financial crisis, manufacturing employment in Mexico was contracting at an annualised rate of around 15%. In mid-2010, it was growing at an annualised rate of nearly 12%.

In Mexico, as in other countries, a strong upturn in employment is consistent with an upturn in household incomes and consumption. Consumption may also be boosted by higher borrowing by households. The overall level of household borrowing in Mexico is low – at around 30% of GDP. Already there have been clear signs of an upturn in borrowing.

The key themes in Colombia, Peru and Chile are broadly the same. As is the case across Latin America as a whole, debt levels are low and banking sectors are in good shape. The economies have been boosted by the general strength in commodity prices over the last eighteen months or so. The forthcoming Presidential election may cause some volatility to financial markets in Peru.

In Colombia, by contrast, there has been a clear improvement in the overall level of risk since this year's election as President of Juan Manuel Santos. Colombia's security situation appears to be moving in the right direction. In Chile, the reconstruction efforts following the massive earthquake of late February will accelerate spending from the Economic and Social Stabilisation Fund. Already, a pick-up in retail sales in Chile indicates that a recovery is underway.

As noted above, there has recently been a strong improvement in the appetite for risk of investors worldwide. During September, the US FOMC issued statements which pointed to a new round of Quantitative Easing (QE II) in coming months: this is consistent with weakness in the US Dollar and a further delay in the ultimate tightening of policy by the Federal Reserve. It also appears that investors are less concerned about the fiscal problems of developed countries than they have been in the recent past.

We also note that the governments of Latin America have more to do in terms of structural reform if the region is to achieve sustainable growth. Investment needs to be targeted in order to eliminate infrastructure bottlenecks. In some cases, more work needs to be done to improve the quality of government spending and/or to address social security deficits. Some countries are burdened by overly complex tax codes. Most need to ensure that greater resources are allocated to education. Even though the general investment environment for Latin America is favourable, it seems to us that valuations are fairly undemanding. According to Citibank, across the region as a whole, Earnings Per Share (EPS) should rise by around 49% this year and by a better-than-respectable 20% in 2011.

Forward Price/Earnings (PE) multiples are around 14 times for 2010 and a little under 12 times for next year.

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