EMERGING MARKETS: RENEWING THE PROMISE

After nearly five years of underperformance, emerging market equities have regained some favor from global investors this year.

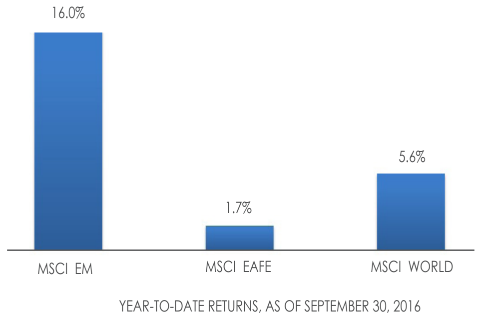
Still, many investors worry about the risks, perceived as well as real. Is it yet another false dawn that could quickly fade when the U.S. Federal Reserve starts talking more firmly about rate hikes? Or could the pessimism reappear if commodity prices falter again?

We believe emerging market fundamentals are much healthier now, when compared to recent years. We do see growth stabilizing in China while India, Indonesia and some of the other Asian economies are accelerating. Commodity exporters are gradually recovering, also helped by lower political risks. Unlike earlier, domestic demand has become the growth driver for the emerging world and rate cuts by central banks are helping consumer spending. Finally, and most importantly, emerging market corporations are now becoming more confident in their revenue and earnings growth outlook.

KEY TAKEAWAYS

We believe emerging market fundamentals are much healthier now. China's growth has stabilized and other Asian economies are accelerating. Not surprisingly, emerging market corporations are now becoming more confident in their revenue and earnings growth outlook.

EMERGING MARKET EQUITIES HAVE GAINED MOMENTUM



Data source: MSCI

GROWTH DIFFERENTIAL WITH THE DEVELOPED WORLD IS WIDENING

For nearly a decade before the 2008 global financial crisis, the appreciably faster economic growth in Emerging Markets attracted global investors. At the peak in 2007, emerging and developing economies were expanding at an annual pace of over 8.5%, compared to around 3% for the developed world. After the dip in 2008 and 2009, short-term fiscal spending by governments helped emerging economies accelerate again. However, as commodity prices started to moderate and global trade slowed, growth in emerging economies cooled off. Last year, when the developed economies expanded at an average rate of 2%, emerging economies registered a not so impressive 4%.

Nevertheless, it now appears likely that emerging markets could regain some momentum and widen the growth differential with the developed world. The International Monetary Fund estimates that the average growth rate for emerging markets could rise to 5% annualized by 2020 while the developed countries are unlikely to expand faster than 2%. Though the pace is nowhere close to the pre-crisis high, even a moderate acceleration would be much appreciated in a world starved for growth.

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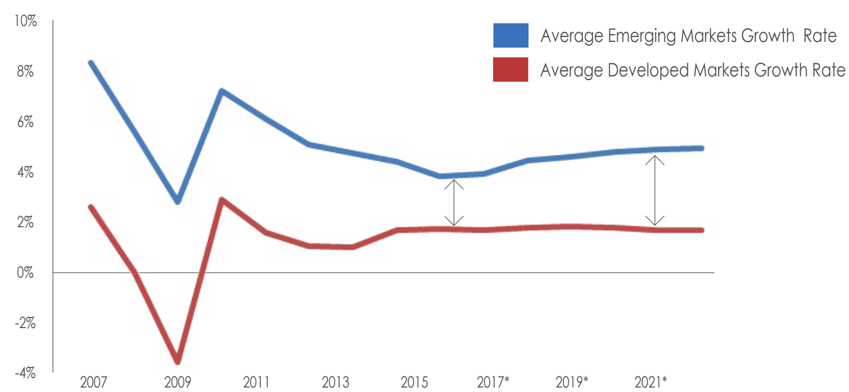

*Forecasts
Data source: International Monetary Fund

ENERGY AND COMMODITY PRICES: NOT TOO COLD, NOT TOO HOT

The sharp decline in energy and commodity prices did benefit large importing countries such as China, South Korea and India recently. But the abrupt fall in export realizations hurt Brazil, Russia and other emerging countries, and pushed some of them into recession. The weak outlook forced energy producers and mining groups to cancel or delay capital investments, hurting equipment manufacturers and their suppliers even in countries that have benefited from low commodity prices. On balance, the boost from cheaper commodities for the emerging world as a whole fell short of expectations.

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After this year's rebound in the prices of crude oil and other industrial materials such as iron ore, the outlook for resource exporting countries has brightened. Brazil and Russia are expected to emerge out of recession, while most Latin American countries should expand faster by next year. At the same time, commodity prices have not moved high enough to dampen growth rates in China and other resource importers.

GLOBAL COMMODITY PRICES ARE BEGINNING TO SEE A REBOUND

MOVEMENT OF THE IMF ALL COMMODITY PRICE INDEX, 2005=100

Data source: International Monetary Fund

INTEREST RATE CUTS TO BOOST CONSUMPTION

Inflation risks have eased in most major emerging economies in recent years, partly helped by low commodity prices as well as subdued global demand conditions. In addition, infrastructure and other structural improvements over the last decade have removed some of the inefficiencies that had kept consumer prices high in several of these countries. As a result, inflation expectations have also lessened and have allowed central banks in China, India and Indonesia to cut benchmark rates over the last year. If inflation remains under control, consumers in these countries could see even lower borrowing costs in the near future.

However, some Latin American countries including Brazil continue to see relatively higher inflation trends. The steep currency declines last year had pushed up import costs, though the situation has eased this year as exchange rates have stabilized. The flexibility of central banks in these countries to cut interest rates is likely to remain restricted in the short to medium term.

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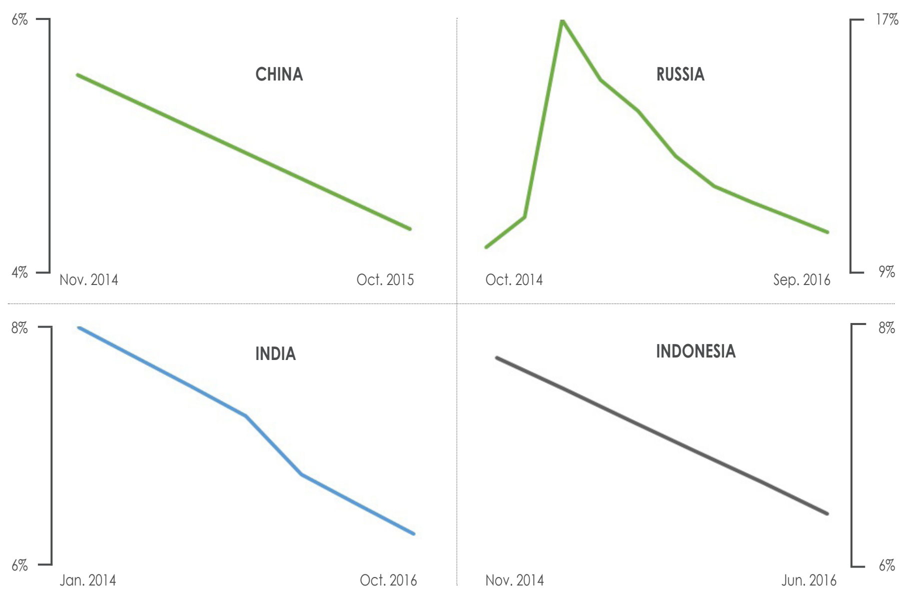
BENCHMARK INTEREST RATES IN SEVERAL MAJOR EMERGING MARKETS HAVE FALLEN



Data source: Central Bank of the Russian Federation (CBR), Bank Indonesia (BI), People's Bank of China (PBC or PBOC), Reserve Bank of India (RBI)

GOVERNMENTS IN SELECT COUNTRIES ARE PUSHING REFORMS

After dramatically opening up their economies to join the globalizing world, and enjoying the growth boost afterwards, governments in several emerging countries lost the urgency to initiate more reforms to support businesses and make them more competitive. In some countries, governments became embroiled in corruption scandals and lost the political goodwill to make policy changes. The relatively new governments in India and Indonesia do not have those constraints and are now pushing significant policy initiatives. Both governments are also proactively taking steps to reduce corruption and make it easier to do business in their countries.

Political risks in other emerging countries have also eased, though some of the governments have become more authoritarian and their policies have become somewhat unpredictable. Brazil has a new government that has promised policy measures to revive the economy. Governments in South Africa and Malaysia are facing corruption allegations, but the risk of these governments losing power appears low. If the political environment calms down further, it is possible that these countries could see more policy measures that would enable faster economic growth.

EMERGING MARKET CURRENCIES HAVE RECOVERED

The improved economic growth outlook and lower political risks have helped several emerging market currencies, led by the Brazilian Real, to recover this year. The reduced prospect of interest rate hikes by the U.S. Federal Reserve and the negative rate environment in the Euro-zone as well as Japan have also boosted investment inflows to emerging market assets, raising their currencies further. This recovery and continuing stability could give global investors more confidence in increasing their exposure to emerging market assets.

To conclude, the economic and political environment in several large emerging markets has become more favorable for businesses to grow their revenues and earnings. Years of slow demand growth have forced emerging market corporations to trim their costs and become more efficient. Some of them have used this period to invest in capacity expansion that should help them grow their market share. We are now seeing early signs of a revival in earnings outlook, across most sectors, in emerging markets. If the environment remains supportive and earnings cycle continues to revive, emerging market equities may deserve more favorable consideration from international investors.

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— Thomas S. White, Jr., Portfolio Manager

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