Monthly Commentary: Emerging Markets

December 2012

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	2012			Annualised Returns	
Index (Total Return) % change in US$	**Dec**	**Q4**	**12 Months**	**3 Years**	**5 Years**
MSCI EM	4.9	5.6	18.6	5.0	(0.6)
MSCI EM Latin America	6.5	4.4	8.9	0.4	0.1
MSCI EM Asia	3.5	5.9	21.2	6.2	(0.3)
MSCI EM EMEA	7.9	5.9	22.5	6.6	(2.0)
MSCI World	1.9	2.6	16.5	7.5	(0.6)

Ten Year Government Bond Yields (%)	**Dec 2012**	**Sep 2012**	**Dec 2011**	**Dec 2010**	**Dec 2009**	**Dec 2008**	**Dec 2007**	**Dec 2006**
US$	1.76	1.63	1.88	3.30	3.84	2.21	4.03	4.70
£	1.83	1.73	1.98	3.40	4.02	3.02	4.50	4.73
¥	0.79	0.78	0.99	1.13	1.30	1.17	1.50	1.68
€	1.32	1.44	1.83	2.96	3.39	2.95	4.33	3.95
JPM EM Bond Index Global	4.50	4.78	6.08	6.13	6.71	9.25	6.64	6.48
EMBI Global sovereign spread	2.66	3.08	4.26	2.89	2.94	7.24	2.55	1.71
Gold Price (US$/oz)	1,676.23	1,772.03	1,576.38	1,418.75	1,098.60	875.32	833.05	635.70
Oil Price (Brent blend – US$/barrel)	111.94	113.25	107.58	94.30	77.20	41.76	93.89	60.13

It would be difficult to improve on the IMF's October summary of the current global economic outlook: *"The recovery continues, but it has weakened. In advanced economies, growth is now too low to make a substantial dent in unemployment. And in major emerging market economies, growth that had been strong earlier has also decreased."* Developing economies continue to provide the bulk of the IMF's 1.5% global growth estimate for 2013, but are affected by the tortuous unwinding of the developed world's debt overhang, mainly through the slowdown in global trade. Consequently the distribution of returns in emerging markets in 2012 mirrored that in the developed world; economically-sensitive sectors, such as materials, energy, and industrials, all underperformed the overall MSCI EM Index's 18.6% return. Countries with a heavy exposure to these sectors were also poor performers, such as Brazil, Chile and Russia. Better performing sectors were those with relatively predictable cashflow, such as consumer, healthcare and telecoms (although technology and financials also did well). This mirrors the outperformance in developed markets of "safe" consumer stocks, especially those with a growth kicker from their emerging markets exposure. By historical standards, capital is cheap in the developed world and readily available for "safe" investments, and this definition now seems to include anything with a semblance of predictability in generating income or cashflow.

The IMF has often said that the improved performance of the emerging market economies over the last decade is due to better policy choices. However, it has also emphasised that these choices have boosted growth by lengthening the duration of the upturns rather than muting the magnitude of the downturns. Therefore, investors seeking temporary "safe" investments in emerging markets may be disappointed. Conversely, those with a longer term perspective should continue to do well in the asset class, where the best companies have the ability to use volatility or downturns to their great advantage.

During the course of 2012 the Rousseff administration in **Brazil** showed determination in its attempts to kick-start economic growth. Intervention to reduce banking spreads was followed by the use of electricity generation concession renewals to bargain lower electricity prices. We believe these moves are well-intentioned as companies frequently cite the cost of doing business, and in particular the inefficiency caused by a lack of general infrastructure, as barriers to investment. 2013 will test these policies, given the large pipeline of projects (roads, rail, ports and airports) earmarked for auction, the first in the context of historically-low real interest rates in Brazil. In the meantime Brazil remains a challenging place to manufacture.

We managed to avoid the resulting squeezed profit pools in utilities and the state sector (including Petrobras), but this was offset by the disappointing performance of OGX, a company in which we identified many positive characteristics (having a large and attractive portfolio of oil exploration assets coupled with an entrepreneurial and low-cost mindset), but which demonstrated the risks of rapid project development in the context of an immature corporate culture.

2012 marked the leadership transition for the Communist Party of **China**. The government had a single focus for the year – to land the country on a stable patch. Politically it wanted the leadership change to be as uneventful as possible, at least to outsiders. Economically it still needed to address the side effects of the post-crisis stimulus and shore up an economy that had started to slip since mid-2011. Both tasks proved to be more challenging than expected.

After growing at above 9% for the last three years, China's GDP growth rate fell to 7.6% in the first half of 2012, a level very close to the government's target of 7.5%, which can be seen as the minimum acceptable level. Power consumption, often a good indicator of the level of activity in China, grew by only 4.3% in June, which prompted many to speculate that the actual growth rate was even lower than the reported number. The key variable that led to the deeper and longer slowdown was the government's suspension of infrastructure projects following a serious railway accident on a new high-speed track in July 2011, thereby switching off a major growth engine. For most of 2012, the government resisted calls for policy relaxation or other stimuli. Only late in the year, after the People's Bank (PBoC) relaxed monetary policy and the government gradually re-started infrastructure projects, did the economy finally show signs of stabilisation.

It has been more difficult to manage a political soft landing. Despite the government's work to deflect bad publicity arising from a series of scandals, from food safety to the serious railway accident mentioned above, an intense power struggle led to the revelation of a series of serious corruption cases. These events catalysed a swift and complete power transition so that the incoming party secretary, Xi Jinping, was able to consolidate power even before taking office. Xi became the first party secretary to assume the role of head of the military from day one. In contrast to the procrastination before the Party Congress in November, Xi moved quickly to address corruption and government bureaucracy, bringing a breath of fresh air to a political scene that had become increasingly stale. His first provincial tour to Shenzhen and Guangdong even led to comparisons with the famous Southern Tour of Deng Xiaoping in 1992 that brought China back on the reform track after the infamous clampdown of 4th June 1989.


Xi Jinping's first tour – following in the footsteps of the great reformer?

We cannot predict how long Xi's political honeymoon will last, but China needs further reform if it is to double its 2010 GDP and per capita income by 2020, a goal set by the Party Congress. Urbanisation has been identified as a key driver for long-term growth and the government recognises that both economic and social reforms are needed to boost domestic demand. Reform-minded policymakers at the PBoC and other parts of the government have laid out credible plans. Recent messages that the government will rely more on market forces raise the hope that the private sector may be able to regain some ground that has been lost to the state-owned enterprises. As we enter 2013, views are generally positive on near-term growth and some initiation of reform. However there remains pressure from local governments to start another round of stimulus to cover their stressed balance sheets, at least temporarily. This could prove a good test of the strength of the new government.

The slowdown in China's growth has had a significant impact on corporate earnings. Profitability has been squeezed between slower top-line growth and a sticky cost base. Of the portfolio holdings, CRE and Parkson struggled to find the right balance between growth and profitability, while the better quality consumer names and property holdings stayed resilient and continued to gain market share.

Two themes emerge from the messy political transition in **Egypt**. One is the noisy but generally positive development of the democratic institutions and the other is the financial cost of the upheaval. It is encouraging that whenever the military or the President tries to direct the process of change, at each undemocratic intervention the public rises and Egypt inches towards a more representative process. The controversial referendum on the new constitution in December was a case in point, with public debate between Islamists and secularists on the content of the constitution and parallel debates on the process itself, including whether it is in the interests of democracy that President Morsi pushed for a referendum in a short timeframe. New parliamentary elections are due 60 days after the referendum, which should finally enable longer-term policymaking and reform.

Egypt is in a tight spot economically because social spending must address the poverty and inequality that fuelled the calls for change two years ago. The economic program announced by the government in November was supposed to restore stability through fiscal consolidation, but unaffordable energy subsidies persist. This underlines the need for elections and a government with a strong mandate. The budget deficit in the fiscal year to June 2013 is likely to stay around 11% of GDP and interest rates are high as a result. IMF assistance would provide welcome relief and unlock aid from the Gulf, and is becoming urgent as faltering confidence increases pressure on the Egyptian pound. Companies in the portfolio are largely exposed to overseas demand – and hard currency earnings – so should feel limited effects of the domestic slowdown (El Sewedy among other things is involved in sub-Saharan electrification; OCI's fertiliser feeds the global market). Meanwhile local banks report rising investment by domestically-focused consumer companies that see the downturn as a time to take market share.

Looking at industry sectors in 2012, starting with **commodities**, the prices of most industrial metal prices held up reasonably well given the weak global economic backdrop. Copper and the platinum group metals finished the year around the same prices they started it, masking a dip in the middle of the year from which prices recovered. Demand held up while continued supply problems provided firm price support. Those commodities of more abundant supply, energy coal, iron ore and nickel for example, lacked this support and finished the year down, although the iron ore price, for example, had bounced some 60% by year-end from its mid-year trough.

Anglo American had a torrid year, not only facing generally weaker product prices but also continued doubts over its capital allocation process centred on its large, costly and much-delayed Minas Rio iron ore project in Brazil. These issues were reflected in the company's poor stockmarket performance over the year, but some disconnect became apparent between debt and equity market perceptions. In late September, the company issued US$750 million of five-year debt with a coupon of 2⅝ %. That paper is now yielding a shade over 2%: cheap money by any standards. Meanwhile, First Quantum Minerals continues on its growth path, successfully commissioning a new project in northern Finland and announcing a substantial expansion to its flagship mine in Zambia as well as two new projects in that country. The company ended the year with a flourish by bidding for a fellow mid-tier copper miner with a large undeveloped project in Central America.

2012 marked the third consecutive year of **consumer** stock outperformance. Organic earnings growth in 2012 was typically strong, with companies benefitting from lower raw material costs and thus margin expansion, even though top-line growth slowed a little compared to 2011. Space expansion continues for retailers in emerging markets, Magnit in Russia being a fine example, on track to increase its sales area some 30% in 2012 with over a thousand new stores, including 50 hypermarkets. Standout stockmarket performers, however, also had a following wind from M&A – Thai Beverages from the tussle with Heineken over Asia Pacific Breweries and Andina from consolidation within the Latin American Coca-Cola bottling system.

Even though the consumer story in emerging markets remains thematically strong, business quality is mixed and some companies are struggling with the transition to new growth phases where factors driving prior successes become redundant e.g. Parkson Department Stores' response to shopping mall expansion and X5's attempts to strengthen its retail operations against a backdrop of rising competition in Russia. However, this trend seems less pronounced in 2012 than 2011, probably because the economic environment is a little less harsh. We are also beginning to see some evidence of successful restructurings of fallen angels, often with private equity involvement.

In **technology**, 2012 was the year where the winners of the smartphone revolution became clear. The leading emerging market technology firms, of which TSMC and Samsung Electronics form the core, benefited not only from rapid volume growth in 2012, but also the many years of patient investment in their respective businesses which has allowed them to dominate the key profit pools in their markets. The question at this point is how these companies will sustain success, and what new profit opportunities have been created with one billion mobile internet devices in the hands of emerging markets consumers.

Portfolio turnover in 2012 was just below 20%, in line with the previous two years and the long-term average. As in 2011, India saw the largest net deployment of assets, with three new holdings: **Kotak Mahindra Bank**, car manufacturer **Maruti Suzuki** and **Cognizant**, an IT services firm that complements the holdings in Infosys and TCS. Sales there were chiefly in the materials and healthcare sectors. Brazil and Russia also saw increases, while **Anglo American** and **América Móvil** were the companies with the largest purchase activity. América Móvil is the largest telco in Latin America and following huge capital expenditure (due to be completed in 2015) now has the most extensive cable network in the world. Elsewhere, a number of new ideas were identified during the year in the consumer sector, most notably in China and Thailand.

On the sell-side, money was removed from Taiwan and South Korea, largely via profit-taking in **TSMC** and **Samsung Electronics**, and there were major sales of **Femsa** and **ICBC**. However the main story was the reduction of assets in Indonesia (to half of the end-2011 weighting). It is a vibrant economy, but the stockmarket's strong performance over the last four years has led to rich valuations; exposure was reduced in cement, telecoms and banks.

For the fifth successive year the composite Genesis portfolio outperformed the MSCI EM Index, this time by 2.7%. Some of the smaller emerging markets achieved strong returns in 2012 having rebounded from a difficult 2011, most notably Egypt and Turkey, with the latter gaining over 60% in US dollar terms. India and Mexico were the top performing major markets, each gaining over 25%, with the Asian giants China, South Korea and Taiwan a little way behind. Russia underperformed the composite benchmark but the notable laggard was Brazil which was flat on the year in US dollar terms, not helped by a 9% weakening in its currency. This bucked the trend of most EM currencies strengthening against the US dollar in 2012.

Turning to the portfolio, the largest contributors to the relative return were the technology leaders TSMC and Samsung Electronics, followed by the consumer companies SABMiller and Magnit. The share prices of three companies more than doubled during the year: two banks, Yapı Kredi (Turkey) and Banorte (Mexico) and the Thai retail developer Central Pattana. The largest detractors were OGX and Anglo American, whose issues have been highlighted earlier.

Asia was again a fruitful region for the portfolio, with significant outperformance in Thailand, Taiwan, South Korea, Indonesia and India, with only China disappointing. Elsewhere, decent gains were achieved in Brazil, due to the underweight position, and in Turkey. Outside the MSCI, Nigeria reversed its recent underperformance as the portfolio holdings gained 60% in aggregate. Along with China, where the property companies did well but there was underperformance in most sectors, South Africa had a negative impact, due to Anglo American.

Year-end weightings in the portfolio's largest markets, China (13%), South Africa (10%) and South Korea (10%), are broadly in line with the end of 2011. India is up from 8% to 10%, funded by Brazil being slightly lower at 7% and Indonesia halved to 3%. The largest sector weightings of financials (26%), consumer (17%), technology (16%) and materials (14%) are similar to last year, with energy (down from 10% to 8%) the largest mover.

Despite the positive outcome in 2012 the expected return of the portfolio remains in double digits. We forecast that earnings growth in 2013 will accelerate to the mid-teens following approximately 10% growth in 2012. While pockets of the portfolio appear expensive, particularly some consumer holdings, others remain attractive, most notably in the financials and materials sectors. Our estimates suggest that, in aggregate, the companies we follow in Russia and South Korea are on single-digit earnings multiples for 2013, with companies in the major markets of China and Brazil trading only a touch higher. Enticing, we believe, given that we are talking about the best quality companies in these countries.

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