

INVESTMENT NOTE

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Emerging Markets

Are the emerging markets becoming overheated?

Recent tensions in Egypt and Tunisia have highlighted the fragility of emerging markets; not necessarily economic fragility, but fragility of sentiment. Following overall strong performance in 2010, investor sentiment has quickly soured leading to significant outflows from funds investing in emerging regions. Below we ask if this is a knee jerk reaction to the Middle East unrest, or symptomatic of a wider problem.

Political Unrest and Short term weakness: Scottish novelist John Buchan once wrote in his Middle East novel “There’s a hot wind blowing from the east, and the dry grasses wait the spark.” Certainly, the political and social unrest in Egypt has brought the prospect for emerging markets (including the Middle Eastern states) under greater scrutiny. The 21% fall in the Egyptian stock market (currently closed) will have caused many to consider de-investing from the region; however given that it represents only one percent of the MSCI Emerging Market index, its overall effect is muted.

Weighing more heavily on emerging markets than Egypt are global inflation fears, prompted by red-hot economies. India’s inflation rate, for example, was 9.5% in December last year, up from 8.3% the month before; its stock market has tumbled 14.1% this year. Soaring commodity prices in general and higher food prices in particular, hit emerging markets hard given their population spends about half their income on food, against fifteen percent for those in developed nations. At TAM, we believe that rising food prices have been the catalyst to the drive for political change. This is a feature of managed economies which have historically subsidised their food and fuel in order to secure political dominance. It is a distortion which is often overlooked in macroeconomic analysis, as too are poor political regimes as a factor in foreign investment flows – both direct and through stock markets. Such factors are easily swept aside when exciting new markets are rising at 30% per year with low barriers to entry. Those barriers are now rising, particularly among emerging economies trying to put up walls to the rising tide of cheap printed US dollars which threaten to undermine their exporting economies. What we are witnessing is a global currency devaluation war.

This is a difficult set of circumstances to reconcile with the perplexing assertion from Ben Bernanke, Chairman of the US Federal Reserve, that Quantitative Easing (QE) is NOT responsible for the rise in global food prices (which are priced in US dollars) – rather it is the growth in emerging economies, he says. We accept that emerging market growth does indeed lead to growing demand for meat and dairy at the margin, in other words, consumers “trading up”. And we accept that there have been floods, drought and pestilence to explain some of the cuts in global supply. Shares in agricultural companies have been rising at a speculative pace. However, growth in emerging markets is not a new phenomenon. It has been recognised for years and free and open economies have adapted to it naturally over time. Fuel is also a big input cost to agriculture – and, of course, crude is now above \$100 a barrel. China is particularly concerned about rising food prices where some basic foods rose 20% last year, and has just raised its benchmark one-year lending rate by 0.25% to 6.06%, following two rate rises late last year.

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Both China and Brazil face similar soaring inflation and any moves by their respective governments to curtail its growth through monetary policy or reserve requirements, for example, are not welcomed by investors.

With continued Quantitative Easing in the West and much of that liquidity making its way into emerging market economies there is little indication that inflation will be brought under control any time soon. With continued unrest in Egypt, investor profit-taking, and portfolio reallocation (to more developed markets) we expect emerging markets to remain weak in the very short term. However, emerging market economies will endeavour to prevent a material strengthening of their currencies and well-flagged quarter-point rises in interest rates, whilst putting rising pressure on their currencies, will not derail strong GDP growth – which ultimately drives up equities.

A Positive Long-Term Outlook: Though concerned about the short term prospects for emerging markets our long term investment outlook remains positive and we believe that emerging economies will outperform developed ones, especially as debtor nations struggle with burdensome borrowing levels. Improving demographics and burgeoning middle classes (in the case of India and China) will increase domestic demand and ensure that such economies do not remain simply the manufacturing hubs of the world. Previous periods of political stability have brought with them improved economic policies, creating much more stable markets; though this may appear temporary in the more frontier markets. The high commodity prices, which have led to higher inflation, and potential civil unrest (as described above) have actually been beneficial to commodity producers who have used the proceeds from higher prices to strengthen domestic finances. Indeed whereas in the early 1990's only five percent of emerging market countries were rated investment grade now just over fifty percent of the market value of the MSCI Emerging Markets Index is considered investment grade.

Despite obvious signs of a slowdown in growth for many of the emerging economies in 2010, growth itself will continue at a high level. Last month, the international Monetary fund (IMF) predicted that China and India will again be amongst the world's fastest growing economies with growth rates of 9.6% and 8.4% for 2011, against a global growth prediction of 4.4%. It remains to be seen if this growth translates into stock market out performance, as last year, or not.

In conclusion, we will maintain our current allocation to the emerging markets area, but remain alert for signs of further possible weakness. Although such exposure will never form a large part of our overall portfolio allocations we believe it an important one which is an integral part of a diversified investment stance for our growth orientated portfolios. Looking forward our strategy will remain to focus on the more developed of the emerging economies and less so on frontier economies (Eastern Europe, New Asia) which we feel face far more complicated dynamics.

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