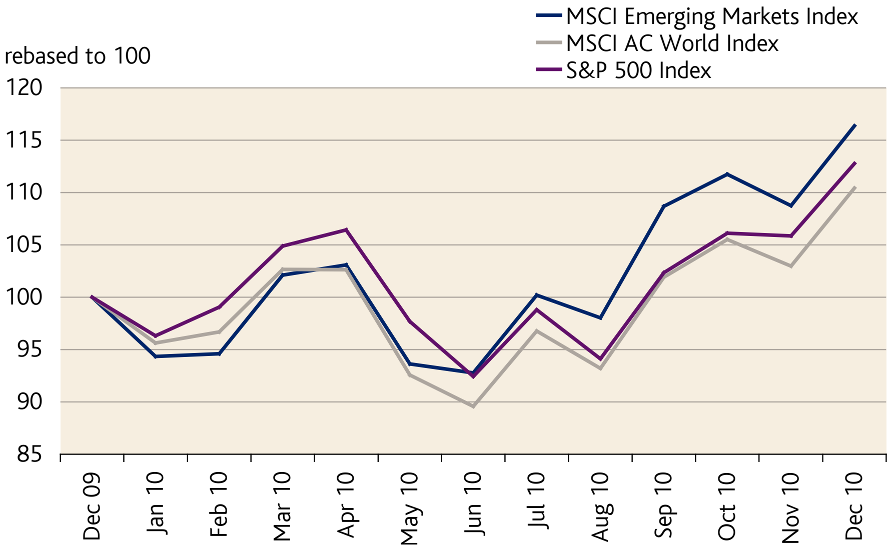
Emerging Markets Equities

Aberdeen

Overview

Emerging stockmarkets had a good 2010, following very strong performance the previous year. Emerging equities have snapped back faster and stronger than their developed peers in spite of a still uncertain backdrop. The MSCI Emerging Markets Index gained almost 20% in US dollar terms over the past 12 months, outpacing the MSCI AC World Free and S&P 500 indices, which returned around 13% and 15% respectively over the same period.

2010 global emerging markets performance versus developed markets



Source: Bloomberg, 3 Jan 11

The underlying performance during the year, however, was choppy. What were initially buoyant stockmarkets lost their footing in April and May because of recurrent fears over Europe's sovereign debt problems and China's monetary tightening in the face of an overheating property market. The US's faltering recovery and Hungary's imprudent comments that it might face a Greek-like debt crisis added to anxieties over a potential contagion. But equities bounced back after the summer, encouraged by the ECB/IMF bailout of Greece, continued growth in key emerging economies and improved corporate results. Foreign capital, in search of higher-yielding assets, coupled with expectations that the Fed would unleash another bout of quantitative easing lent further support. The momentum remained largely uninterrupted for the rest of the year, though November saw markets stumble briefly following the unprovoked artillery attack on South Korea by the North.

The rally was led by EMEA, notably Turkey and Russia, which ended significantly higher than their regional peers. Their robust economic resurgence dominated newsflow, allowing these markets to largely sidestep worries over the fiscal woes of their less prudent European counterparts. Similarly, the emerging Asian markets of India, Indonesia, the Philippines, Malaysia and Thailand benefited from sustained economic expansion. Even South Korea finished almost 30% higher, despite the North's brinkmanship. In comparison, China and Brazil concluded on a modest note. Chinese shares were hit by the authorities' stern measures to curb lending in certain non-productive sectors, while Brazil was buffeted by domestic interest rate concerns and cooling measures in China, its largest trading partner.

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Outlook

Looking ahead, robust growth in the developing world and continued loose monetary policies in advanced economies may well continue to drive emerging equities. But volatility is likely to persist as structural imbalances, rising inflation, international currency disputes and Europe's debt problems continue to dominate market attention in 2011.

Structural imbalances are a significant headwind for emerging markets. Developing economies, which were instrumental in cushioning the global impact of the recent crisis, are anticipated to continue expanding on the back of a domestic consumer boom and rising intra-regional trade. By contrast, growth in the advanced nations is likely to languish amid fiscal consolidation, chronically high unemployment and soft housing markets. Indeed, the IMF estimated that emerging economies will grow by 6.4% in 2011, almost three times the rate of developed nations. Given the opposing interests of deficit and surplus economies and the ensuing lack of coordination among major central banks, it remains unclear if there will be any substantial headway in resolving the imbalances in the global economy.

Then there is the growing risk of inflating asset prices and currencies. This risk stems from the two-track global recovery that has resulted in divergent policies being pursued by advanced and developing economies. Policymakers in emerging markets now face the dilemma of having to tame inflation and moderate capital inflows concurrently. So far heightened inflation risks have led to tighter monetary conditions in countries such as Chile, China and India, while the surge in foreign capital have seen others, such as Brazil, Thailand, South Korea and Indonesia, step up intervention to neutralise currency appreciation. Although these controls have exacerbated trade tensions with the West, more countries look set to implement measures to prevent the flood of cash from destabilising their economies.

An escalation of the European debt crisis and a double-dip recession in advanced economies could also unsettle markets. Ireland, with its insolvent banks, has followed Greece in seeking multi-billion dollar aid. Yet the bailout had failed to quell fears that the crisis could spread to the Eurozone's financially fragile periphery; Spain, Portugal and Italy are perceived to be among the most vulnerable. Another downturn in the developed countries or the US would undermine exports and by extension economic activity in emerging countries, given many are fundamentally trade-led.

In light of the uncertainties ahead, we remain cautious in our outlook for the coming months. Our holdings, however, are still in good shape, as reflected in their sturdy balance sheets, improved profit margins and strong cash generation. In the long term, emerging economies' growth prospects look attractive compared to the developed world. Fiscal prudence in recent years has strengthened emerging economies' finances. This will provide governments with a fallback should global recovery falter. Structural rebalancing in emerging economies is also expected to continue, with the shift in focus from exports to domestic consumption supported by huge populations and rising affluence.

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Important information

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