



FLASH REPORT

Emerging Markets Update

October was one of the worst months ever in the history of global financial markets. By almost any measure, every metric of the financial market was down at or near record levels. Most importantly, October was when the effects of the problems in the credit markets that began last summer started to become evident to the general public.

LIQUIDITY HURTS. Of the many events during the past few months that went contrary to both historical trends as well as common sense, none was more striking than the adverse effect the presence of liquidity has had on many stock markets. This has been especially true in emerging markets investing. The smaller countries have been outperforming larger countries during this year's market decline. We do not believe that any claim can be made for the superiority of investing in these countries; indeed many appear to be among the highest risk countries in the asset class. The same facts that made them relatively poor investment options for global investors a year ago, most notably the relative lack of liquidity, actually helped these markets more recently. They were not sold off by global investors, simply because they were never owned in the first place.

	<u>October</u>	<u>3 Months</u>
Philippines	-24.3	-27.7
Morocco	-10.2	-28.3
South Africa	-24.7	-37.6
Chile	-25.4	-36.6
Jordan	-18.8	-29.9
EM	-27.3	-44.2
BRIC	-28.8	-49.1

This pattern of large stocks in an index underperforming the smaller ones has been repeated in most of the major emerging markets.

RESCUE PLAN – NECESSARY, BUT SUFFICIENT?

There are now two bond markets, so removed from each other that they have become alien beings, despite facile similarities. "Flights to quality" – the sharp and sudden divergence between government backed bonds and riskier corporate and mortgage bonds are not unusual. But never has there been such a clear distinction between US Treasury bonds and basically everything else. These credit spreads have become credit chasms. Perhaps the best way to evaluate the complete disconnect between segments of the fixed income markets is to look at their relative returns.

<u>CATEGORY</u>	<u>13 WEEKS</u>	<u>YTD</u>
Intermediate US Government	2.6	5.7
Corporate Bond	-12.7	-13.2
Merrill Lynch High Yield Master II	-23.0	-25.2

The difference in returns has also caused a disconnect in yield. Investment grade bonds are yielding more than twice comparable treasuries. For high yield, convertible and similar fixed income assets, yield is now 3-5 times that of a similar duration treasury.

Although it feels like an eternity, it has been less than six weeks since the TARP (Troubled Asset Relief Program) was announced by the Treasury Department, rejected then resurrected, and has continued to morph to this day. Most nations have engaged in some combination of lower interest rates, recapitalization of banks and loosening of lending requirements to restart credit markets that had been stressed for some time, and completely froze this summer. The purpose of these plans is to effectively transfer the excess liquidity (and therefore high valuation) from the Treasury sector to the other, less liquid sectors. Actual cash outlays from the program (and from similar programs abroad) were delayed and have only recently been distributed. Thus far, these efforts have produced incremen-

tal results – encouraging, but with a long way to go. LIBOR rates have declined steadily, yet measures of actual bank lending remain well below last year's levels.

Outlook. By the time you read this, the election will be over. Newgate does not believe that the results will matter that much, except for the removal of uncertainty. Both candidates will be caught between the desires to stimulate the economy,

protect taxpayers and mind the deficit. The exact proposals that come forth from the new administration will matter, but these details are unlikely to be revealed for several weeks, if not months, after the election. The best outcome is the orderly deleveraging of the global economy and a reduction in market volatility. Both will take time and patience from investors and governments. ♦

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