NEWGATE
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• FLASH REPORT: EMERGING MARKETS •

Portfolio Update

Two seemingly unrelated factors roiled financial markets in January and affected almost all asset classes but hit emerging markets the hardest. The MSCI Emerging Markets Index was down 5.6%. The first was China's change in monetary policy, requiring banks to increase loan loss reserves and making small increases in interest rates. Effectively these actions tightened money supply after a year of unprecedented bank lending. The question that financial markets are grappling with is: "Do these changes reflect a fine tuning of existing policy or do they signal a change to a more restrictive policy?" Newgate believes it is premature to suggest that China is engaging in a systemic tightening of monetary policy, but this must be carefully and continually re-evaluated.

The second was financial problems in the developed world, particularly the debt issues of the smaller European countries, notably Greece and Portugal. While there is almost no direct impact on any emerging market, as with Iceland's similar difficulty in 2008, fears of sovereign debt default anywhere causes a flight to fixed income assets and the US dollar, which is negative for emerging markets equities.

Chinese equities fell 8.6% during the month, not surprising as China led the news cycle. Chinese energy and materials stocks declined, but the Portfolio had gains in Chinese technology and in Macau gaming stocks. Commodity-producing countries also had substantial declines. Brazilian equities fell 10.9%, led by energy and materials stocks. We used this weakness to increase exposure to these sectors.

Unlike most of the other commodity-heavy markets, Russian equities climbed 2.4%. Russian stocks remained at reasonable valuations last year, despite their sharp appreciation. So while Russian energy companies had modest declines, increased investor willingness to hold Russian companies resulted in positive overall returns. The Russian economy contracted 7.9% in 2009, the largest decline of any major country, developed or developing. As a result, growth in 2010 will look greater, given favorable year over year comparisons.

The other major markets in Asia all declined: Taiwan -6.5%, Korea -4.4% and India -5.3%. Though to somewhat different extents, those three countries are battling inflation and have expectations of higher inflation, with the specter or rising interest rates stifling their economic recovery.

The recent global correction is not surprising. Last year's rapid pace could not be maintained. Investors would prefer flat returns as the markets wait for further confirmation of economic growth. Although there are signs of recovery, market psychology remains fragile, and there are still major uncertainties. As the recent European debt crisis has caused a reduction in risk appetite, in a way it highlights the relative health of the major emerging market economies that have much less debt on their balance sheets. ◈

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