



NEWGATE
CAPITAL MANAGEMENT LLC

February 2010

FLASH REPORT: EMERGING MARKETS

Portfolio Update

Emerging markets had a stable February, with the MSCI Emerging Markets Index gaining a modest 0.37%. The global macroeconomic environment has not changed much in the past few weeks. The global economy continues to show signs of steady, if unspectacular growth. Most economists suggest that employment in the US has stabilized, which apparently now means losing fewer jobs than forecast. The expectation is that job creation will be evident in the next few months.

The Greek debt crisis, though it has no direct economic impact on emerging markets, still provides an overhang on financial markets generally. This impact is most keenly felt on the Eastern European markets of Poland, the Czech Republic and Hungary, each falling approximately 5% in February. These countries also share the structural deficiencies of the weaker developed European markets (not just Greece) of high budget deficits and sluggish economic growth. The Russian market fell 5.2%, surprising in that energy prices rose during the month.

The most important issue directly impacting emerging markets is the sustainability of Chinese economic growth. This not only affects Chinese stocks but also impacts major exporters to China, including the commodity exporters in Brazil, Russia and Southeast Asia, and also the technology and industrial hubs in Taiwan and Korea. The debate is confusing because there are multiple issues discussed simultaneously. We believe these issues are best disentangled by time frame:

Short Term – The Chinese government is adjusting policy, removing some of the measures instituted at the beginning of the crisis. This should slow economic growth, but more

importantly, limit inflation and mitigate any damage to the Chinese banking system.

Medium Term – Monetary policy in China has been very loose, with incredible amounts of lending by banks, very often into commercial and residential real estate projects. Invariably, some of these loans will end up being unpaid. The debate is the extent of the bad loans on the balance sheets of Chinese banks, the timing of their realization and their impact given the trajectory of Chinese growth.

Long Term – It is now a given that the Chinese government must reorient the economy to focus on domestic needs and less on exports to the developed world. The question is, can this happen fast enough to maintain what the Chinese refer to as “social harmony?”

These are complex questions, and they may not be resolved for years. Newgate believes that the long term path of Chinese economic growth remains intact. The Chinese economy will continue to grow, likely similar to the way the US economy grew as it emerged from a backwater ex-colony to an economic and political superpower. The difference between Chinese and US growth is in the time frame. China must do in a matter of decades what it took the US over a century to accomplish.

The short term outlook provides a much greater challenge. We have maintained an allocation of nearly 24% to Chinese stocks this year. Though a tightening monetary policy presents an undeniable headwind to the Chinese stock market, the change itself is a clear sign that the policy was effective in mitigating the worst of the global recession. We do

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not believe that Chinese stocks appropriately reflect the success of the government's actions. The markets are obsessed with the side effects of the medicine, and have forgotten that the medicine worked and the patient is healing.

The Chinese market rose 2.2% in February, making it among the better performing markets for the month. The Chinese government is having the National People's Congress presently. Few major new initiatives are expected to be announced, but subtle phrasings will be examined closely for signs of meaningful policy shifts. The Chinese currency remains pegged to the US dollar, with many economists and the currency markets forecasting a revaluation of this peg in the near future despite official denials from the government. The current strengthening of the US dollar further validates the decision to maintain a large portion of the Portfolio in this very strong Chinese currency.

Latin American equities were positive in February, with most countries up approximately 4.5%. Asian stocks were mixed. Taiwanese stocks lost 3.7% and Korea was down 0.7%. Indian equities rose 1.4%. Newgate's investment decisions in these regions have been increasingly driven by valuations, rather than dictated from top-down decisions.

There have been reports that some of the diversified mining companies might bid for specialty fertilizer companies. The big picture is much simpler. Increased agriculture yield is the only way to meet growing demand, and a relatively small number of companies in the fertilizer and agriculture technology industries will be able to meet this demand. We believe that the agriculture sector has secular growth potential, far beyond the current business cycle. ♦

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