



FLASH REPORT: EMERGING MARKETS

*Portfolio Update*

Emerging markets declined sharply in May, losing 8.8% and erasing gains from the first four months of the year. Given the inherent volatility in equity markets, and the strength of emerging markets last year and in early 2010, some profit taking had been expected, and we had reduced risk in the Portfolio accordingly. There are two factors impacting emerging markets: the ongoing European debt crisis and concerns regarding a Chinese economic slowdown. A number of emerging market central banks either have or were expected to increase interest rates. Given the current market volatility, we believe that these banks may delay or scale back rate increases for now.

The European debt crisis, now well beyond Greece and affecting Spain, Portugal and potentially other countries as well, has no direct impact on emerging markets except for Eastern Europe. To the contrary, fear is spreading to more developed markets. However, emerging market equities remain subject to investors' appetite for risk. Fear has pushed nervous investors into treasury bonds and currencies such as the US dollar and Japanese yen.

The Chinese economy has a direct impact on emerging markets, not only on its own equities but throughout Asia and the commodity exporting countries of Latin America. The Chinese economy has responded positively to monetary policy changes implemented in the wake of the global credit crisis of 2008. However, those policies have led to a rapid acceleration of the economy, with a sharp rise in real estate values and concerns about bad loans in Chinese banks. The government has started to reverse these policies, though it has not officially increased interest rates.

The market appears to have two concerns about China: first, that the government is too late and that a bad debt crisis is brewing, and second, that the economy will slow dramatically. The latter can be seen in declines of commodity companies in China, but also in Brazil, South Africa and non-emerging market commodity producers like Australia.

We disagree with forecasts of a severe slowdown in China. While there are likely to be inevitable bad

debts in the banking system, they should be manageable given the overall size and underlying strength of the economy. Though China had underperformed the MSCI Emerging Markets Index so far this year, it outperformed in May, down 5.6% relative to the 8.8% decline in the Index. Most emerging markets managers are underweight China. Should the market continue to outperform, they will be pressured to buy shares to avoid unwanted tracking error from the Index.

China's weight in the MSCI Emerging Markets Index was increased to 18.7% with the addition of several new securities, as well as a reallocation in the Index driven by Israel's assignment to developed market status. Newgate's allocation remains approximately 25%. We have been adding to consumer and financial companies. Stocks in both sectors are well off recent highs, and we believe they adequately reflect a government engineered economic slowdown.

The Taiwanese market was down 9.8% in May and has been one of Asia's worst performers year to date. Economic growth has been good, but Taiwan is heavily dependent on technology exports to the US and China. This makes Taiwan more globally sensitive than other countries that are more domestically focused, such as India and China. India was down 8% in May. Most of the decline was due to the rupee's 6.5% depreciation against the US dollar. We see no specific reason for this decline, other than a general preference by investors to keep money in "safe" currencies. The Indian economy has been growing, and its central bank is raising interest rates to curb inflation.

The South Korean market fell 13.3%. Tensions with North Korea added to the already challenged market psychology. However, the underlying economic data in South Korea are strong. South Korea's export oriented economy is likely to benefit from a strong US dollar, which boosts the Chinese yuan as well. What cannot be known is the outcome of the latest incursion by North Korea. A shooting war on the Korean Peninsula is not in the interest of any player in the region, including the US and China. After this recent decline, South Korean shares are now very cheap, under 12x

current earnings and under 9x expected earnings for 2010. Newgate is presently market weight South Korea.

In Latin America, Brazilian stocks lost 10.5%, mostly due to declining commodity prices. The central bank has been raising interest rates, and while rates may not be increased as quickly as originally predicted, they are still likely to go up. The Brazilian economy has strong domestic demand, and the unemployment rate is almost down to pre-2008 crisis levels. We remain overweight Brazil, especially in areas like materials and telecommunications.

The Eastern European countries had sharp declines, with the Czech Republic down 12.1%, Hungary losing 22.5% and Poland down 14.7%. All three countries have struggled with debt issues in the recent past, and the current situation in Southern Europe provides an unpleasant reminder. Among emerging markets, these countries are the ones with the most direct economic ties, and therefore have the most potential for

true negative impact. The Portfolio has no exposure to these countries.

We believe that, to a certain extent, the emerging economies have decoupled from the developed world. Global equity markets have not decoupled, nor are they likely to. However, if we are correct that the economic impact of recent events will be limited in the emerging markets, valuations in these markets have once again become attractive. Based on current earnings, emerging market price/earnings ratios are now in the mid-teens, with some markets like South Korea below 12x. On a forward basis, assuming only modest negative impact in these countries, valuations have fallen below 10x forecast earnings. This debt crisis is demonstrating to global investors that some of the perceived safety of developed markets has been illusory. In contrast, emerging markets are becoming a relatively safer investment as the developed world deals with its growing debt crisis. ♦

## DEFINITIONS:

The MSCI Emerging Markets Index is a free float-adjusted market capitalization index that is designed to measure equity market performance of emerging markets. As of May 27, 2010 the MSCI Emerging Markets Index consisted of the following 21 emerging market country indices: Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey.

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