Economic View

As so much of the bad news that hung over markets in recent years continues to recede, we expect to see an improvement in business and consumer confidence. We believe this will provide a broad-based investment opportunity this year, particularly in equities.

We reduced our holdings in UK Gilts towards the end of last year, and since then have reinvested the money in areas of the market that are on relatively cheap valuations and that are more sensitive to global economic conditions.

As we explain in this article, we believe emerging market equities tick both boxes.

C. Hoare & Co.
PRIVATE BANKERS SINCE 1672

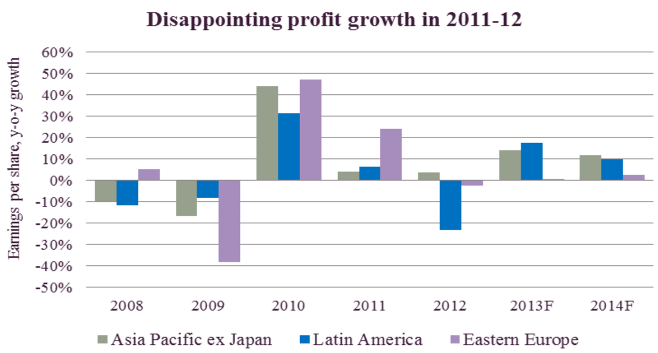
Setting the scene in emerging markets

We believe that encouraging economic conditions and current low valuations are compelling reasons to consider investing in emerging market equities. Our positive outlook for the asset class follows some significant developments in the region in recent years.

In 2009, huge stimulus packages implemented by the Federal Reserve and other main central banks were successful in avoiding a global depression, but they triggered a chain of less fortunate events in the developing world. In 2010, countries there began to experience capacity constraints, due to a lack of infrastructure and necessary inputs such as readily available resources and skilled labour.

These limitations were compounded by rising commodity prices and led to higher inflation. Central banks in these emerging markets reacted by raising interest rates, which restricted the flow of credit and economic growth.

At the same time, companies in the developed world were forced to cut or even cancel new orders as they tried to draw down unwanted inventories in light of the poor economic conditions. This reduction in demand for emerging market exports hit corporate margins and profit generation in 2011 and 2012, as shown below.



Source: Morgan Stanley, as at 31st December 2012

The case for investing

Forecasts for economic growth in both the developed and developing markets are stabilising rather than deteriorating, and we are further encouraged by equity profits that are expected to rise by 13% this year and 10% in 2014. With current valuations below their medium-term averages, we see this as an attractive entry point.

Reductions in government debt ratios and consumer debt risks have given us more comfort over the medium term. Emerging markets are still playing catch up in terms of education and technology levels, and there is the potential for them to make gains in these areas through higher GDP growth, while youthful demographics are also a positive factor.

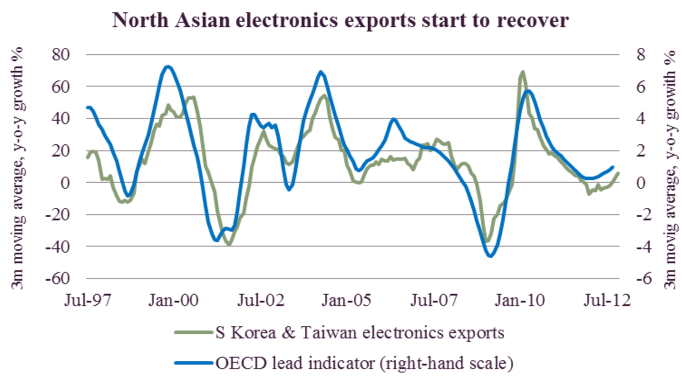
The inclination and ability of central banks in emerging markets to use further stimulus packages remain risks, however, as does the lack of productivity growth and reform measures. These last points are particularly relevant to China and India.

A decade of strong export growth began to test the limits of China's economic capacity, which was exacerbated by the $850 billion stimulus package in 2009. As a result, bank lending, residential property investment and inflation were all seen as risks, leading to tighter monetary policy. The effect of this was a steady decline in growth forecasts, as shown in the following chart.

Source: Consensus forecasts, as at 31st December 2012

China's new leaders have acknowledged that stability will be better served by growth of around 7.5—8% per annum and, to achieve this, they have an objective of implementing structural reform, for example in financial deregulation and social service provision. If these reform measures are passed, we would expect the Chinese market to perform well, especially given an improvement in the global trade outlook.

As far as India is concerned, the country's economic progress has been challenged by inflation, a high fiscal and current account deficit and a sense of political paralysis and corruption surrounding essential infrastructure investment. In recent months, however, we have seen an improvement in the momentum of reform, with sectors such as retail and aviation opening up to foreign investment.



Source: Ecowin, as at 30th November 2012

In the rest of Asia, the manufacturing countries in the north of the region have suffered from weak exports, poor business investment and modest consumer spending in 2011 and 2012. Export growth has picked up in the last quarter, which should presage a return to more normal growth levels.

In the medium term, South Korea and Taiwan are both trying to shift to a more service-orientated economic model. This requirement is largely in response to the growth of China and the impact it has had on their manufacturing bases. A positive example would be increased tourist arrivals to Taiwan, which are up 54% year-on-year from China and 20% from Japan.

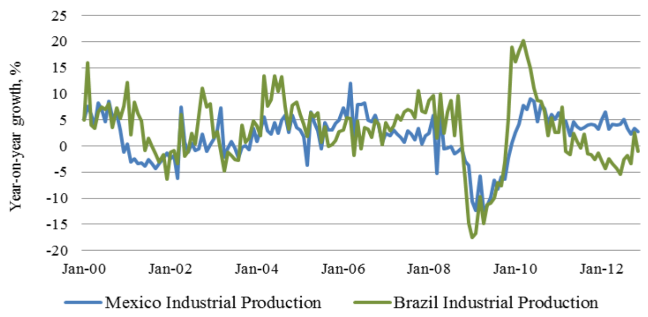
Southeast Asian countries have generally benefited from their own distinctive growth drivers in recent years, with Indonesia a good example. However, Indonesia's commodity-led growth has led to increased imports and current account weakness, illustrating the continuing vulnerability to global capital flows, despite positive Foreign Direct Investment and consumption trends.

We are conscious that some commodity-producing nations such as Brazil have benefited tremendously from China's industrialisation over the last decade, and these gains are unlikely to be replicated in the years ahead.

Brazil's economic growth slowed sharply in 2011 and 2012, following interest rate hikes, and the manufacturing sector lost competitiveness because of the country's strengthening currency. Brazil's growth is forecast to pick up from 1% to 3.5% in 2013, the best improvement in the major emerging markets, and will be supported by strong employment figures and real wage gains, which are benefiting private consumption.

Another important country to watch is Mexico. Unlike Brazil, Mexico has benefited from good performance from its manufacturing sector in recent years, and we expect it to make further gains as the US economy continues to progress.

Manufacturing could be set for recovery



Source: Bloomberg, as at 30th November 2012

What about Emerging Europe?

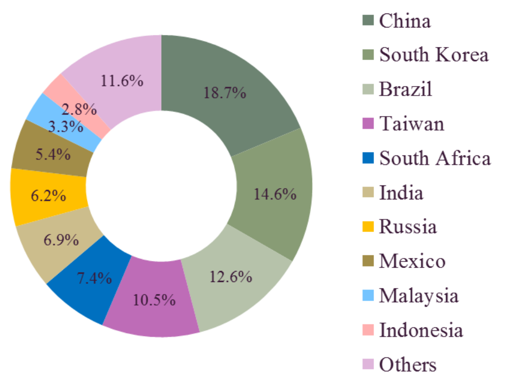
Eastern European exports and industrial production slowed sharply because of the Eurozone crisis, and a funding squeeze by Western European parent banks has restrained credit conditions, particularly in Hungary. Fiscal austerity has also reduced growth. Inflation trends are moderating, however, and the region should benefit from some recovery in Germany.

Russia has tightened monetary policy this year to counter inflationary pressures. Growth in Russia's economy is expected to remain stable at 3.5%, and new fiscal rules linking expenditure to the oil price should improve stability and allow equity valuations to rise. This would be assisted by further reform and privatisation to improve overall corporate governance.

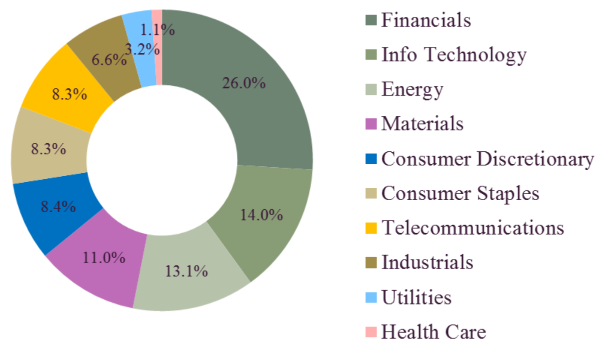
Our investment decision

Given our assessment of the broad-based prospects on offer in emerging markets, we have invested in a fund that tracks the global emerging markets index. Our decision to invest in a passive vehicle was taken because it provides greater exposure to cyclical sectors than we could have achieved through an actively managed fund.

Country allocation of the passive fund



Sector allocation of the passive fund



Source: BlackRock Advisors (UK) Ltd, as at 25th January 2013

If developments in the region progress as we expect, companies involved in areas such as consumer discretionary, energy and materials should lead the recovery, particularly as they have underperformed in recent years relative to defensives.

Most actively managed funds are more heavily biased to domestically focussed, defensive sectors, such as those containing tobacco, telecommunication and utility companies. These sectors could struggle to keep pace, at least in the shorter term given that their recent outperformance has left them on reasonably full valuations.

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Important Information

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