InPerspective:

MARCH 2011

Developed versus emerging markets

AT A GLANCE

- Emerging markets have largely dominated the global growth story since the financial crisis.
- But since October 2010 they have underperformed developed markets around 10%.
- Investors have become concerned about rising inflation and interest rates in China and India.
- Instead, investors have been drawn to the US's blend of ultra-loose monetary policy and impressively strong recovery.
- Does this mean the investment case for developing economies is under threat?
- Or is this a temporary rotation that ultimately provides a tactical buying opportunity?

The story of last year was emerging markets. For growth investors, there was only one show in town. That was until October when a sharp reversal of developed and emerging market fortunes took place. Since then, the weakness of emerging markets in relation to developed markets has been marked; emerging markets have underperformed developed markets around 10% and are lagging over 12 months.

With continuing unrest in North Africa and the hint of a banking crisis in South Korea, volatility in emerging markets looks like it will continue, but what are the implications for investors?

WHAT IS THE EXTENT OF THE SHIFT?

Analysts from Bank of America Merrill Lynch have compared this period of emerging market underperformance with the four previous times it has happened in the past decade - in the summers of 2002 and 2007 and the springs of 2004 and 2006.

They found that this period of underperformance has lasted three times longer than others – around 90 days compared to an average of 28 days – but is less severe in terms of absolute performance and performance relative to developed markets. On average, emerging markets have fallen 14 per cent in these four periods, compared to one per cent now, and in relative terms have underperformed on average by 14 per cent, compared to 11 per cent now.[1]

AND ITS IMPACT ON FUND FLOWS…

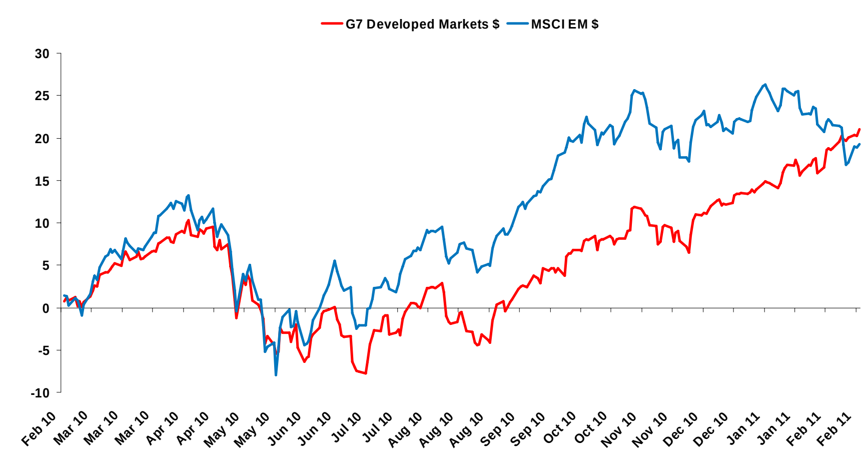
Since October, $13bn has been withdrawn from emerging markets. But this is just 1.9 per cent of the total assets under management in the region. The average outflow was 4.2 per cent in the four periods over the past decade and for that to be repeated, a further $16bn would need to leak from emerging markets.[2] This either suggests that there is still a long way for this trend to run, or that this is a trade with low conviction. Or, perhaps, both.

Close analysis of the fund flows indicates a high proportion of the assets leaving emerging markets are from ETFs and that non-ETF flows into emerging market funds are positive so far this year. This implies that long-term investors are holding firm and only shorter-term speculative ETF investors are withdrawing assets.

"My best guess is that there is more downside ahead of us for emerging markets in the next several months which will set up another tactical buying opportunity, but probably not just yet."

Jeff Hochman, Director of Technical Research

COMPARATIVE PERFORMANCE OVER 12 MONTHS



Source: Datastream 17/02/11

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SO WHAT IS HAPPENING?

Does this rotation reveal a fragility that suggests the beginning of the end of the emerging market investment case?

In short, no. There are several reasons for the reversal, none of which suggest an end to the long-term case for emerging markets.

Investors have woken-up to the strength and potential of the US recovery, and enthusiasm for fast-growing economies has been dampened by efforts to rein-in inflation. One has pushed up developed markets, the other has pulled down emerging markets.

At the end of 2010, after almost two years of interest-rate inactivity, China started dabbing the brakes on economic growth with several interest rate rises.

Meanwhile, the US's ultra-loose policy and spare capacity has pumped up its recovery and, to a degree, demand from the US has fanned the flames of emerging market inflation. Under such circumstances investors have sensed value in US stocks and shifted assets there.

The emerging countries that have suffered the most in this period of underperformance have been those battling with inflation like China. At the sector level too, those which have tended to be most sensitive to higher inflation have performed the worst such as consumer staples and consumer discretionary sectors. This is because the outlook for consumers worsens as they begin to feel the pinch of rising inflation.

NEW YEAR ROTATION

It is not uncommon for last year's losers to get off the best start in a new year. Citigroup believes it might be in part due to investors' contrarian instincts being at their strongest when the slate is wiped clean in January.[3] The bank points out that emerging/developed market performance is not the only pattern to have been reversed. Large companies are outperforming smaller ones, financials are recovering and Southern Europe is making up ground on Northern Europe. But the bank is quick to point out that the so-called "contrarian trade" does not tend to hold much later than the spring. The bank's conclusion is that this reversal is a temporary adjustment.

EARNINGS REVISIONS AND IMPROVING RELATIVE VALUATIONS

Since 2000, there has been a strong and quite logical correlation between the outperformance of emerging market 12-month forward earnings per share and the outperformance of that region's equities. In essence, investors have been optimistic about future emerging market earnings and were rewarded for their faith.

During the current period of underperformance, however, expectations of earnings in emerging markets have not weakened in relation to expectations for developed markets.

Given the faster economic and revenue growth momentum of emerging markets this is not surprising and it seems unlikely that the correlation has broken.

So with earning expectations remaining stable, relative valuations are becoming more attractive in emerging markets. This applies to earnings-based valuations and others. Citigroup points out that the consensus dividend yield for emerging markets stocks in 2011 is higher than for developed markets and in spite of higher profitability, emerging market price to book is on a par with developed markets.

"LVMH is one of my preferred consumer lays in the luxury goods sector along with Burberry and Richemont. These companies are well positioned to benefit from rapidly growing demand in emerging markets."

Alexander Scurlock, Portfolio Manager,

European equities

NOT ALL EMERGING MARKETS ARE THE SAME

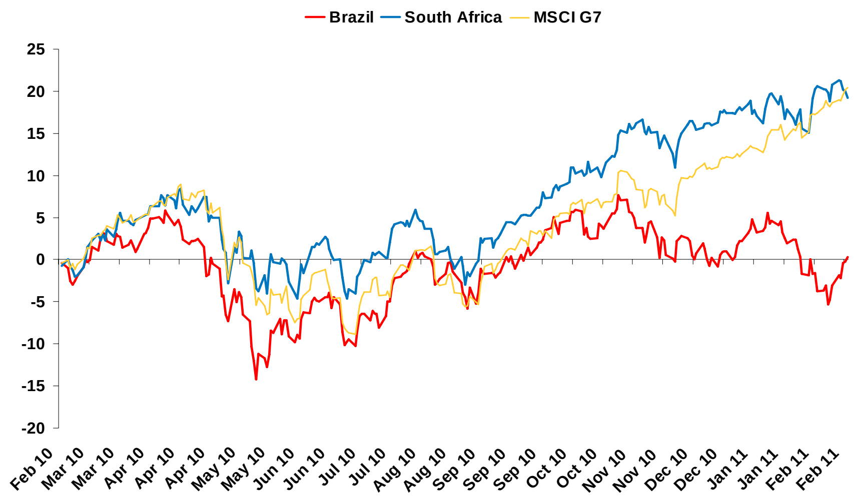
It is important to remember that emerging markets are not one market. For example, in local currency terms, since the beginning of this year, over six and 12 months South Africa has kept pace with developed markets despite its emerging market peers lagging behind. Over a year, Brazil has flat-lined, while the G7 and Johannesburg stock exchanges have returned more than 20 per cent each.

THE BEST OF BOTH WORLDS?

For some investors, the distinction between emerging and developed markets is beginning to disappear altogether. Globalisation means that many firms have established strong positions by exploiting both sides of the story. Investors can gain access to the long-term growth of emerging markets while enjoying the reassuring governance and regulation that is familiar to them closer to home. One example, luxury goods maker LVMH, is rated highly by Fidelity's equity research team and owned by several of our portfolio managers. With operations on a truly global scale and listed in Paris, the company offers investors the best of both worlds.

InPerspective:

NOT ALL EMERGING MARKETS HAVE UNDERPERFORMED - SOUTH AFRICA HAS COMFORTABLY BEAT BRAZIL



Source: Datastream 18/02/11

"Over the last two decades the emerging markets have benefitted from superior growth rates, improving public finances and strengthening currencies and we expect these long term trends to continue."

Trevor Greetham, Asset Allocation Director

CONCLUSION

There was huge consensus through the final months of last year that emerging markets were the engine of global growth. This drove fund flows into emerging markets and valuations rose. There was a degree of inevitability about this year's correction.

The long-term investment case for emerging markets, however, remains firmly intact. Subtle changes to the story are occurring as China's growing pains are felt through shifts in sentiment and changing investor behaviour. This phase of rate hikes is one - another might arise as China progresses from its position as the world's low-cost manufacturer to becoming a more self-sustaining consumer economy.

The pattern of performance is a useful reminder to investors not to forget the potential of developed markets and to be selective in their emerging market investment. Emerging markets have a habit of surprising investors and it is easy to be caught flatted-footed by a reverse in a trend. Ultimately, investors should ensure they are diversified across both areas.

Underweighting emerging markets can be costly if timed wrong. And if you believe the evidence that the long-term case for emerging markets remains intact, then you might see this period of underperformance as a tactical buying opportunity.

Sources:

1. Bank of America Merrill Lynch, Global Strategy Weekly, Global Rotations and EM Corrections 11/02/11.
2. Morgan Stanley, Asia/GEMs Strategy, "Underperformance likely more than half done" 11/02/11.
3. Citigroup, Global Equity Strategist, 16/02/11.

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