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Review of Emerging Markets

February 2013, with a focus on Central & Eastern Europe and the Middle East & North Africa (MENA) region

Highlights of the month

- Emerging equities fall by -1.4% in US dollar terms in February as investor sentiment hit by a lack of a decisive result in the Italian political elections
- Indonesian central bank highlights strong consumption and investment and expects growth of around 6.5% in 2013
- China's manufacturing sector continues to expand, albeit at a slower pace
- Surveys point towards strong economic activity in Saudi Arabia and the United Arab Emirates

Economic Data

Overview of the IMF's *World Economic Outlook* projections				
(percentage change, year over year)	**2010a**	**2011a**	**2012p**	**2013p**
Output				
Advanced Economies	**3.0**	**1.6**	**1.3**	**1.4**
United States	2.4	1.8	2.3	2.0
Euro area	2.0	1.4	-0.4	0.2
Japan	4.5	-0.6	2.0	1.2
UK	1.8	0.9	-0.2	1.0
Emerging Market and Developing Economies	**7.4**	**6.3**	**5.1**	**5.5**
Central and Eastern Europe	4.6	5.3	1.8	2.4
Russia	4.3	4.3	3.6	3.8
Developing Asia	9.5	8.0	6.6	7.1
China	10.4	9.3	7.8	8.2
India	10.1	7.9	4.5	5.9
ASEAN-5(1)	7.0	4.5	5.7	5.5
Latin America and the Caribbean	6.2	4.5	3.0	3.6
Brazil	7.5	2.7	1.0	3.5
Mexico	5.6	3.9	3.8	3.5
Middle East and North Africa	5.0	3.5	5.2	3.4
Sub-Saharan Africa	5.3	5.3	4.8	5.8
South Africa	2.9	3.5	2.3	2.8
World Trade Volume (goods and services)				
Imports				
Advanced Economies	11.4	4.6	1.2	2.2
Emerging Market and Developing Economies	14.9	8.4	6.1	6.5
Exports				
Advanced Economies	12.0	5.6	2.1	2.8
Emerging Market and Developing Economies	13.7	6.6	3.6	5.5
Consumer Prices				
Advanced Economies	1.5	2.7	2.0	1.6
Emerging Market and Developing Economies	6.1	7.2	6.1	6.1

(1) Indonesia, Malaysia, Vietnam, Thailand, Philippines
Source: Overview of the IMF's World Economic Outlook projections, World Economic Outlook Update, January 2013, p2.

Market Data

Stock Market Indices (US$)	Feb 13	1 Month		3 Months	6 Months	12 Months
MSCI Emerging Markets	1,054.62	-1.35%	▼	4.73%	11.33%	-2.30%
MSCI Eastern Europe	203.49	-5.24%	▼	4.92%	8.00%	-10.18%
MSCI Russia	810.15	-5.60%	▼	6.50%	7.84%	-12.62%
MSCI Arabian Markets ex Saudi Arabia	543.24	-0.89%	▼	3.86%	6.26%	-0.23%
MSCI Latin America	3,824.58	-2.88%	▼	6.82%	8.02%	-10.14%
MSCI Brazil	2,730.88	-2.64%	▼	7.17%	5.12%	-20.25%
MSCI Asia	451.07	-0.16%	▼	4.30%	14.25%	2.04%
MSCI China	62.87	-3.93%	▼	4.83%	19.66%	0.81%
MSCI India	418.09	-7.39%	▼	-2.82%	11.69%	-4.85%

Sources: Bloomberg/ MSCI/Barra

Global emerging markets in February

Investor sentiment was negatively affected by the outcome of political elections in Italy towards the end of February. A lack of a decisive result has the potential to derail recent progress made towards addressing the eurozone debt crisis and this caused the euro and European equities to fall. Meanwhile, the latest economic data suggests that activity remains subdued in much of the euro area, notwithstanding relatively resilient activity in Germany.

In the emerging world, investors also reacted cautiously to the Indian government's budget for the March 2014 fiscal year. The budget includes a 30% increase in capital investment and major social programs, yet the government plans to cut the fiscal deficit from 5.2% of GDP in the current (March 2013) fiscal year to 4.8% of GDP. Although India's Finance Minister Palaniappan Chidambaram spoke of the need to boost growth from 5% to the 8% that had been the norm prior to the onset of the global financial crisis, the budget was seen to be lacking in substantial measures.

Elsewhere in Asia, data releases and central bank comments continued to underline the strength of domestic demand in many economies. Bank Indonesia, for example, noted that the Indonesian economy expanded by 6.23% in 2012. Consumption and investment in the final quarter of the year 'remained buoyant… On the other hand, exports began to improve in line with the economic recovery in some major trading partners such as China.' Bank Indonesia is looking for growth of 6.3-6.8% over the course of 2013.

HSBC noted that its flash Purchasing Manager's Index (PMI) for China's manufacturing sector fell from 52.3 in January to 50.4 in February (a figure of more than 50 indicates an increase in activity). The latest reading suggests that activity in the sector continues to grow, but at a slower rate than in January. Hongbin Qu, HSBC's Chief Economist for China, noted that the 'economy is still on track for a gradual recovery. Despite the moderation of February's flash PMI, the index recorded the fourth consecutive reading above the 50 critical line. The underlying strength of Chinese growth recovery remains intact.'

The latest economic data from Latin America has been mixed. HSBC's PMI for Mexico's manufacturing sector suggested that activity is still growing due to demand at home and from export markets, if more slowly in February than in January. There were various signs of slowing of activity in Brazil. Peru's central bank noted towards the end of February that the Peruvian economy expanded by 6.3% in 2012 thanks to growth in construction, commerce and services. In contrast, Banco de la República, the central bank of Colombia, said that the economy is growing 'below its potential'. With inflation also below the 3% target, the central bank opted to cut interest rates by 25 basis points to 3.75% in order to boost overall economic activity.

Region in focus: Central & Eastern Europe and the Middle East & North Africa (MENA) region

The weakness in Eastern European equities in was substantially the result of the fall in regional currencies relative to the US dollar. This was driven by investor concern over lingering weak economic activity in much of the euro area, as well as the inconclusive result of the election in Italy. At the country level, Turkey outperformed its regional peers, as did the Arabian markets (excluding Saudi Arabia).

Turkey remains a classic example of a large emerging market where the economy is growing steadily, despite the weakness of activity in Europe. At its meeting on 19 February, the Central Bank of the Republic of Turkey (CBRT) decided to keep interest rates unchanged at 5.5%. The CBRT said that 'the rebalancing between the domestic and external demand continues as envisaged. Domestic demand follows a moderate pace, while exports continue to increase despite weak global activity.' Meanwhile, the current account deficit 'continues to decline gradually.' The CBRT will gradually increase the commercial banks' reserve requirements to ensure that the strong capital inflows of capital to Turkey do not destabilise the financial system.

Meanwhile, selected countries in the Middle East continue to enjoy strong economic conditions. For example, in early February Saudi British Bank said that its SABB HSBC Saudi Arabia PMI (which indicates the strength of the non-oil sector) slipped from 58.9 in December to 58.1 in January (a figure of more than 50 indicates an increase in activity). Although the pace of growth in the sector did slow in January relative to December, overall activity remains strong and nearly 45% of firms surveyed 'indicated an increase in new orders, which was mainly driven by improved economic conditions and good sales team efforts.'

In the United Arab Emirates (UAE), HSBC's PMI slipped slightly from 55.6 in December to 55.0 in January (a figure of more than 50 indicates an increase in activity). Economic activity in the UAE is still growing – albeit at a slower rate – and Liz Martins, HSBC's Senior Economist for the region, noted that this was 'another strong reading which adds to [the] sense of a recovery… The strength in [the UAE's] export orders in particular is encouraging, and probably speaks to robust demand elsewhere in the Gulf region, particularly for Dubai's non-oil goods and services.' In terms of the portfolios which we manage across MENA, we remain particularly positive on the outlook for banks and other financial services companies.

The region has a young and fast growing population and this means that banks have the ability to aggressively expand their services in areas such as personal banking, mortgage and insurance products. The local banks also have an important role to play in supporting infrastructure development, which is a key priority for Gulf Cooperation Council (GCC) governments.

In spite of recent adverse political events in Syria and Egypt, we believe there are many opportunities to acquire shares in companies in the MENA region that have good long-term growth prospects and which are currently trading at reasonable valuations.

Meanwhile, we are also optimistic about the outlook for Russian equities. An important development in early February was the announcement by Euroclear Bank that it will begin direct settlement of rouble-denominated OFZ government bonds, of which the total amount outstanding is around US$100bn. This is in effect a liberalisation of Russia's financial markets, and should encourage greater foreign investment in OFZs.

Other reforms in Russia are also positive, in our view, with changes to the pension fund system set to encourage greater participation in the local stockmarket by Russian investors. Elsewhere, legislation has also recently been passed which requires state-owned companies to pay at least 25% of their net profits as dividends. In what remains a low global interest rate environment, this should attract income seeking investors and it is also an encouraging sign of improving corporate governance standards in the Russian market.

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