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EMERGING MARKETS EQUITIES

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Strong fundamentals emerge as macro risks recede

A broad set of risks that were taken as a reason to flee emerging market equities in 2011 has now receded. Stocks should rise as strong fundamentals become more evident.

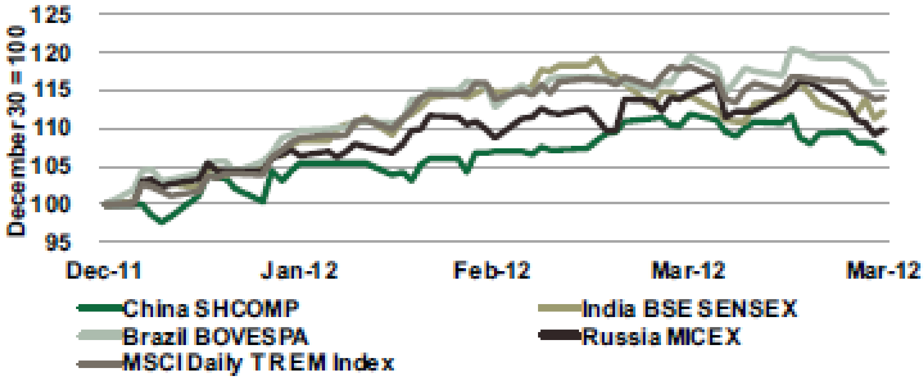
MSCI Emerging Markets Index (Total return)	As of March 31, 2012 3 Months	12 Months
USD Return	14.0%	-8.7%
CAD Return	12.0%	-5.9%

Source: Bloomberg. For illustration purposes only.

A first quarter rise in the MSCI Emerging Market Index of 13.7 per cent has defied investor concerns at the beginning of the year over a U.S. double dip recession, the EU debt crisis rollercoaster, and rising emerging market inflation and interest rates. U.S. recession fears have receded markedly as the U.S. has posted (and continues to post) positive economic data over the last six months. Also, stimulative monetary and fiscal initiatives pursued around the world have likely provided support to emerging market stocks. We see the battle for emerging markets in 2012 raging along the following fronts:

- Declining inflation expectations
- Bottoming earnings expectations, and consequently improving valuation metrics

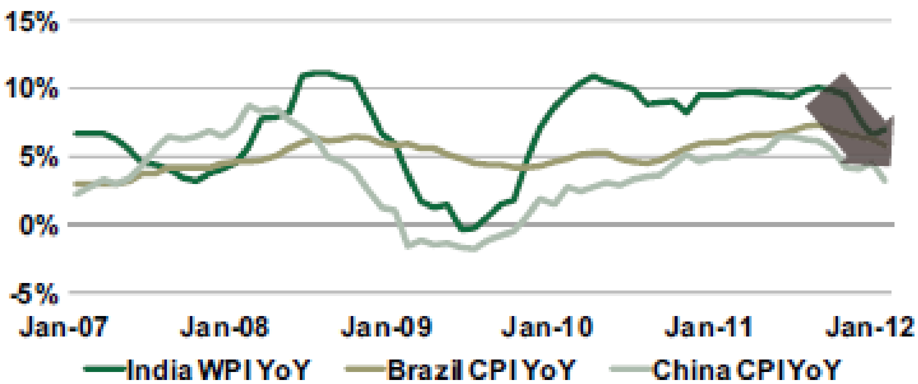
Emerging markets have done well in early 2012



Source: Bloomberg (March 23, 2012). For illustration purposes only.

On the inflation front, we are enjoying favorable base effects in several key markets. China's food inflation has abated and double digit readings in food prices have given way to single digit changes. Certain key food product prices have eased significantly and are expected to continue to fall. India's inflation readings – both wholesale and consumer prices – have moved to a range that gives the central bank room to ease monetary policy. A similar story has played out in Brazil, where price indicators have moved down significantly. Central banks have been taking advantage of normalizing inflation readings by reducing interest rates and bank reserve requirement ratios. The monetary backdrop appears to be pointing to a cyclical upswing.

Easing inflation leaves room for stimulus



Source: Press Information Bureau of India, Institutoe Brasileiro de Geografia e Estatistica, China Economic Information Network (March 27, 2012). For illustration purposes only.

Sources of friction in the recovery phase of this cycle include lack of political commitment to growth policies and the resurgence of inflation as a threat. We would keep an eye on India after the recent state elections failed to strengthen the ruling coalition. The implications of such results could be the inability to push forward necessary infrastructure spending, as well as a less determined attitude toward reducing deficits.

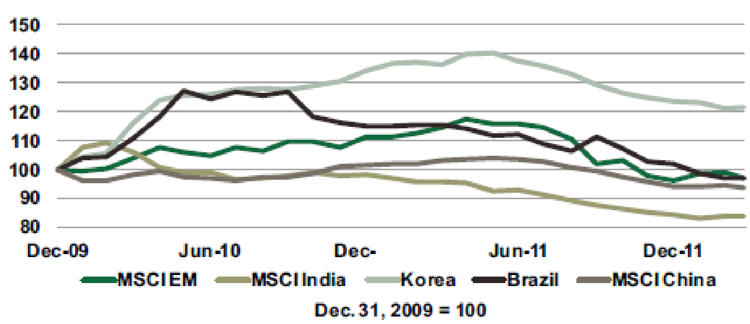
China's economy might well have entered a new real GDP growth range of 7-8 per cent, from 8.9 per cent in the last quarter of 2011 (Beijing is projecting 7.5 per cent, down from the prior annual target of 8 per cent).* With the prospects of a hard landing off the table at the moment, and despite the market's reservations about the lower range of growth, there is confidence in the country's need for and ability to maintain that growth range. The consumer remains a strengthening entity in China and might overshadow the growth concerns.

Earnings forecasts may rebound

Earnings revisions are reaching the inflection point. The market appears to be accepting the hypothesis that we have entered a more positive macro environment, one that is more conducive to earnings growth acceleration. We use earnings forecasts for 2012 to illustrate. The expectations for 2012 fell rapidly during 2011 as the outlook for the global economy deteriorated. At the time when the expectations were formulated, the 2012 macro environment looked to include a declining U.S. economy, a European currency headed into collapse, a Chinese real estate bubble bursting and affecting several economies, a failure in the newly appointed Brazilian central bank leadership, an Indian economy paralyzed by an inactive legislature, etc.

Despite investors' strong conviction in the continuation of above-normal growth in emerging markets, analysts were unable to express positive outlooks for their stocks. We witnessed this phenomenon most significantly in the Chinese auto sector, where valuation metrics reached low levels on account of reduced subsidies, entirely discounting the structural changes that were occurring within the companies themselves, such as new model/brand introductions or acquisitions of new technologies. We also witnessed it in the energy sector, where the positive event of production start-up by fledgling energy companies was greeted by bankruptcy-like valuation multiples.

Earnings estimates may be poised to turn higher



Source: Bloomberg (March 23, 2012). For illustration purposes only.

In a positive macro context free of panic, company fundamentals play a bigger role in stock valuation. With optimism about the economic outlook building momentum as we get into the year, we find it hard to believe that improving fundamentals and expectations should not be reflected in valuation metrics, and ultimately stock prices. We are encouraged by the performance of emerging markets in early 2012 and believe, with macro risks in check, those markets ought to deliver even better numbers in the months to come.

*Source; Bloomberg (March 23, 2012)

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