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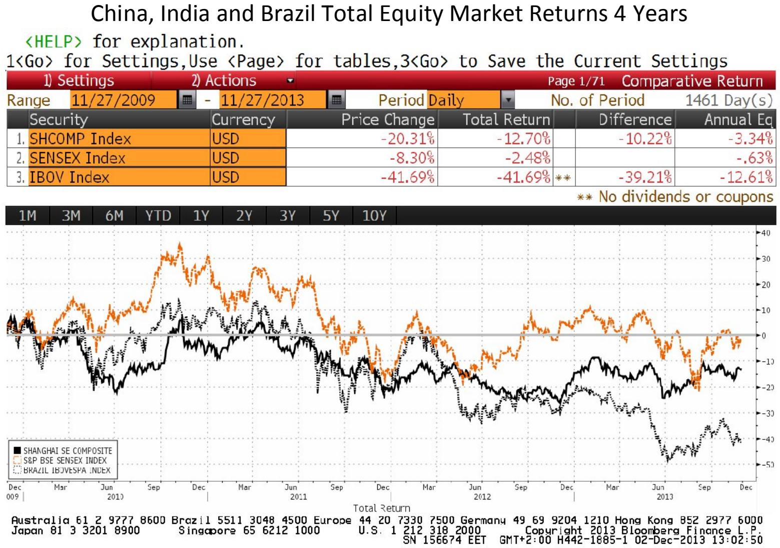
Monthly Commentary 2nd December 2013

Equities were mixed in November with US, Japanese & European equities up while UK and Emerging Market equities fell. Further dovish comments from Janet Yellen, that “unemployment is still too high, reflecting a labour market and economy performing far short of their potential” have given equity bulls further ammunition. Bonds were largely flat, while commodities continue to underperform, and fell 3% last month.

On Emerging Markets

In the developed world, as the fixed income trade became mature, the equity trade took over and performed very well so far this year. The so called “great rotation” out of bonds and into equities seems to be alive and well in developed markets. This is in sharp contrast to emerging markets where despite a fall in bonds, equities have not been in a position to provide high returns. In fact they are still in the red so far this year. More alarmingly, some of the “big” emerging markets, namely China, India and Brazil have actually fallen in value in the last four years, when both equity and currency returns are taken into account. China is down 2.5%, India 12% and Brazil 40%. Not exactly commensurate with their GDP growth!

China, India and Brazil Total Equity Market Returns 4 Years



One of the big drivers of returns in the US and European markets has been the re-rating, to the upside, of valuations. That is to say that equity prices grew much more than corporate earnings did, as the P/E (Price/Earnings) ratio has increased (in financial lingo this is called “multiple-expansion”). Investor confidence is a main driver of multiple-expansion.

So what might 2014 hold for EM equities?

Many financial analysts expect a good rebound in EM equities next year as valuations are considered “cheap”. We are not as sanguine.

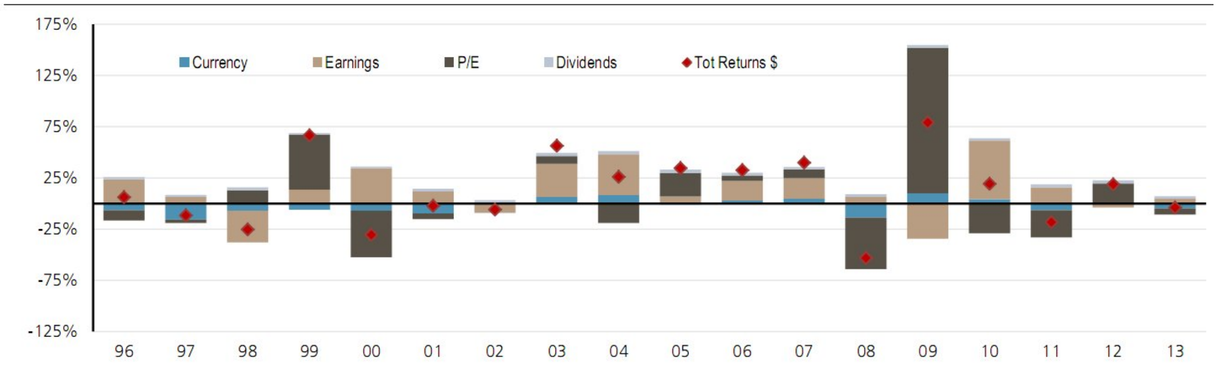
First, we should ask what constitutes the “total return” in equity markets and see how each component will influence returns. The four components are the following:

1. **Earnings Growth**. In an ideal world, this should be the main driver of equity prices.
2. **P/E ratios**. As mentioned above investors tend to give a “higher” or “lower” earnings multiple to each market depending on their collective outlook. This is a significant driver of equity prices.

3. **Dividends**. In emerging markets, dividends have historically played a smaller role in the overall returns, as opposed to their more meaningful contribution in developed markets.
4. **Currency**. As a foreign investor, who invests in USD or EUR, currencies often play a major role in total returns. For example if an EM currency drops significantly, as it did in India this year), positive equity market returns can be wiped out.

Below is a chart from UBS that shows the “total return attribution” of EM markets since 1995.

MSCI EM total return attribution since 1995



Source: Datastream, UBS estimates

As you can see, in the pre-crisis years of 2002-2008, earnings were an important contributor to EM equity gains. Since then, earnings have been missing, something especially evident in the last two years.

For 2014, earnings growth is likely to remain weak, in line with only modest improvement in global trade. Multiple-expansion is unlikely, as potential output is not rising across EM’s. And with the exception of North Asia, EM currencies are likely to remain under pressure.

As such, for the moment, we remain cautious on EM equities. Whenever deemed appropriate, Elgin, invested in EM markets via the best funds, with the best managers. This approach will continue.

In the next quarterly report we shall look at what various investment banks are saying about what might happen across markets in 2014.