

## Market Conference Call Summary: Putting Recent Volatility in Context

Market volatility continues to challenge investors globally. The European debt crisis and a slowing U.S. economic recovery have left many investors wondering whether they should brace themselves for another 2008.

On October 12, Patricia Perez-Coutts, Senior Vice-President and Portfolio Manager of the AGF Emerging Markets Equity strategy and Bob Lyon, Senior Vice-President and Portfolio Manager of the AGF Global Resources strategy, shared their insights on some of the key issues facing global markets today and the potential implications for emerging markets and the resource sector.

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### Patricia Perez-Coutts, CFA

Senior Vice-President and Portfolio Manager  
AGF Emerging Markets Focused Equity strategy

We are in the midst of very interesting and telling times. During times like this, we at AGF Investments feel it's important to be in front of clients and ensure we are providing timely updates to help clarify some of the issues that investors may be facing. There are four key things I'd like to address this morning:

1. The changing landscape
2. Valuations
3. Common misperceptions
4. Opportunities we see in the current environment.

### The Changing Landscape

As has been the case for a few years, emerging markets continue to be at the forefront of both economic growth and economic development worldwide. Yet this remains unreflected in the current markets. In 1987, emerging markets were less than 1% of total world equity market capitalization, and by the end of 2010, it has reached almost 14%, yet in terms of world GDP, emerging markets are contributing close to 50% of the world economy. EM equities currently represent almost US\$14 trillion in market cap, but are expected to exceed US\$80 trillion in less than 20 years.

Further, there have been numerous structural changes made in these markets since the '80s and '90s, which have made them more resilient. While this transformation has not been without its bumps along the way, we feel these are worthwhile because of the learning curve that resulted. We are confident that this path of growth will continue and, therefore, we are very confident that the changing landscape that we are witnessing sets the stage for emerging markets to continue to lead

the world into future growth. In fact, when you look at the growth in GDP terms, we can still count on positive, real GDP growth in almost all the emerging economies that matter.

This is not to say that these economies may not encourage some moderation of that growth. In fact, it's actually prudent to say so given the current status of the entire world economy. Down the road, however, the drivers for this growth are more inherently associated with domestic drivers such as investments in terms of infrastructure and domestic consumption. As such, for 2011 and going into 2015, emerging market GDP growth continues to be very positively associated and should continue to be a driver. Therefore, there continues to be a tremendous disconnect still with the rest of these economic trends and the actual market weight of emerging markets in the global marketplace.

## Valuations

What happens within these economies is very important. The devil is always in the details and not everything should be taken with the same view. Every country of all the 25 emerging economies and developing economies that we follow has different fundamentals. Moreover, the drivers for those sectors are diverse, their competitive advantages are diverse and of even greater importance, the companies within those jurisdictions and sectors are vastly, vastly different. As a result, we've taken advantage of our bottom-up perspective to uncover those important companies.

When we look at the valuations of these specific companies, we see that in several instances, in many metrics (not just only P/Es or price-to-cash but also price-to-book in a trailing manner), emerging markets on average continue to be very attractively priced. If you look at emerging markets currently, price-to-book is between 1.8 and 1.9 times on a trailing basis (doesn't incorporate 2011 numbers). Yet the returns – ROE in this case – are still hovering around 14 to 16 percent. What's more important to our process is that when you look at the price-to-book on a trailing basis, which is the price you pay, and you look at the ROE, there is a trade-off. So in this case emerging markets are 1.8 or 1.9 (i.e., you are paying the 1.8 or 1.9), but you're getting a 15 to 16 percent ROE.

When you compare and contrast these relative valuations to other regions such as North America, Europe or even Asia Pacific, you get higher price-to-books, on a trailing basis. North America is 2.2, but you have relatively lower or meagre returns on equities and the book metric in terms of price-to-book seems to have been overstated. It has become clear that in Europe it was overstated as well, therefore leading to prices declining sharply. So you always have to watch what you're getting relative to what you are paying.

In addition to that, the current dividend yields for emerging markets between 2.5 and 2.8 percent are rather high and, importantly, we are finding that cash flow generation is positive in many of these companies. As a result of the opportunities primarily in consumption trends and in infrastructure investment, strong motivational drivers and a continuing lead of emerging markets, you're really getting a good bang for your buck.

## Common Misperceptions

As is always the case, headlines continue to create misperceptions. We have commented in the past that in the worst possible times, which seemingly are coming again, emerging markets were punished unduly when their fundamentals were significantly better than their developed counterparts. The volatility of emerging markets increased significantly and sharply during the 2008 crisis, but actually bottomed in 2009 when things started to get better, or presumably better in the world.

This time around, volatility has heightened again, yet there is always a case to be made for what causes this volatility. We believe that this volatility is primarily coming from exogenous factors, not from within. The greater proportion of the misperception against emerging markets comes strictly from what's going on in areas such as Europe and the United States. Rightfully so in some instances, but not necessarily when you look at it from a bottom-up perspective, and that's important.

One of the biggest areas of concern regarding emerging markets right now is inflation. At the beginning of the year, we saw inflation creeping up in some areas. You could argue that in some cases, such as India and Brazil, it is coming off of their structural inefficiencies. These inefficiencies are being dealt with by infrastructure expenditure, so you should expect to have some inflationary overtones. But the main culprit at the beginning of the year was food and the demand that was coming about from the year 2010. There were some costs and some instability in many local economies because food has become a very important part of their consumption basket. Central banks never, ever take action to quell food inflation. It's a matter of adjustment that needs to be done.

Post the 2008 and 2009 crisis, when emerging markets also resorted to very pragmatic stimulus packages, they realized that these stimulus packages had gone a bit overboard and that excess liquidity had come in. The economies did well, consumption stayed very strong and as result, other market players outside emerging markets were investing aggressively in this environment. So what we've seen so far is a very pragmatic approach by central bankers to mop up that excess liquidity and therefore to try to actually quell a bit of those expectations.

With regards to food inflation, fast forward 10 months and we see this has diminished significantly. In some areas like India or Brazil, there are significant food inventories that have allowed these markets to actually lower the prices in their domestic economies. This is also the case with other resources such as oil or materials, where these prices also have been on the decline. We should not declare victory yet, but certainly the fact that the growth is slowing down, moderately in the case of the emerging markets, is actually welcome news to continue to stem off these inflationary overtones. Inflation is important – we need it to be there if the countries are growing, but it is definitely pragmatically dealt with by central bankers these days.

In the last couple of months, we've seen several central banks moving to loosening their interest rate environments, a tad less than a few months back. Such was the case with Turkey, Brazil and then, just recently, Indonesia. What they are seeing is moderation in growth as a result of a global slowdown – this needs to be dealt with through lower interest rates but not interest rates that are

going to be continuously declining. I think this is a very pragmatic approach. We're onside with their thought process and welcome the news.

Another area that is cause for concern is China and whether or not it continues to be a global growth engine. We believe it is. This is not to say, however, that there are no issues in China. There are definitely inefficiencies, but we feel that the central bank and the Chinese government have been acting very proactively to address these issues. As an example, by increasing the reserve ratios and raising interest rates, they have cleaned up some of the excess liquidity in the system.

Real estate within China has also been contentious and talks of a real estate bubble continue to surface. While it's true that in some coastal areas of the East, prices have been growing faster and higher, but when you consider national averages, the picture changes dramatically. The main growth in terms of GDP consumption is still coming from outside of the tier 1 cities like Beijing, Shanghai, etc. That's where the main engine of growth is and there is no material inflation per se.

Secondly, in terms of real estate, people in China still put forward close to 40 to 60 percent of their down payments in cash. The rest is borrowed monies from their relatives. Saving levels are very prominent, but as they are looking for ways to spend their cash, it's leading them to spend in real estate. And there have been increases in wages and employment, which means that the affordability levels have continued to outpace the real estate prices. Pent-up demand continues to remain strong and therefore we believe that once these flare-ups of real estate prices in certain coastal cities diminish, we will continue to see positive trends in this space. We have had exposure to the area through three vehicles: China Overseas, Wharf Landing and China Overseas Land and Investment Ltd.

Thirdly, consumption in China is very strong. There was speculation that as population matures, consumption will slow. We do not hold this view – we expect consumption to remain strong. In fact, we just recently went through an important holiday in China called Golden Week, during which sales growth seems to have been around 18 to 19 percent year-over-year, even in a year when you consider moderation has kicked in.

And finally, infrastructure expenditures in the long run are still there to be had. The Five-Year Plan that was written up early in the year calls for important investments in power generation, power grid, railway, urban subway systems, transportation and water resource facilities. This is also complemented by significant and important expenditures on soft areas such as education and insurance and that is very important because it also adds to the equity value of every citizen of that country.

## Opportunities

There has also been much speculation recently about India and Brazil. In the case of Brazil, it is the only country that remains perhaps a little caught up with their interest rate picture. We have no doubt that Brazil will come through in this environment simply because, like Canada, it's a natural resource producer and we strongly believe that the demand will resume in the near future. Further, Brazil is being very pragmatic with respect to its fiscal responsibilities. If you go back to the year 2000 when no one cared about Brazil, they were facing a new president in Mr. Lula who was a union worker with no university education. It's easy to understand why Brazil had become a bit of a pariah nation. Since then, Brazil has actually grown in leaps and bounds. They have stabilized the economy, moved more than 20 million people to the ranks of the middle class from the poor level and are now looking at fiscal policy in much more detail. Under the leadership of Ms. Dilma Rousseff, we strongly believe that Brazil will come out of the current environment unscathed and that growth will resume.

This is also the case in India. India has an important group of companies that have done very well. We strongly believe that consumption and infrastructure expenditures, which are both in their five-year plan, will come to be drivers of growth. Yes, they still have to deal with variations with respect to inflation, but we believe that fiscal prudence is their stalwart and they will continue to come to the fore in that manner.

In conclusion, we continue to see plenty of new companies show up on our screens. Having said that, from our bottom-up perspective, we have actually been investors in countries such as Peru, South Africa and Turkey. We continue to maintain a very broad view and a very broadly diversified portfolio across emerging economies.

### **Bob Lyon, CFA**

Senior Vice President and Portfolio Manager  
AGF Global Resources strategy

For the past few years, we have spoken about the important role that emerging markets (EM) are playing in the commodities space. EM continues to be one of the key drivers of industrial commodities today. If you look back to the Asian crisis in 1997/1998, oil prices were around \$12 and copper was at about \$0.65. Today you could argue that the Western world is in crisis, and we are seeing oil at \$85 and copper at \$3.25. So if \$85 oil and \$3.25 copper is the world in crisis, we are feeling pretty good about the state of the world right now.

Does that mean we don't see any issues at a macro level? Certainly not. Europe, for example, continues to be a concern but we feel they will be able to come to a resolution on their debt issues. Is it going to come smoothly and without pain? Clearly not, but we think there's too much at risk for them to let that fall apart. Interestingly enough, Germany has been the major benefactor of this situation despite the fact that they have been subsidizing certain other parts of the EU. What we're seeing right now is that while yes, global growth is clearly slowing down, the point is we've still got global economic growth. If you compare what's actually happening versus what you read

in the headlines, again, things have slowed down but the reality is not nearly as bad as the headlines would have you believe. When we look at oil demand, it looks like oil demand is still going to be up about a million barrels a day year-over-year indicating that economies are still growing. Now coming into 2011, estimates for growth were that it would be closer to 2 million barrels a day so growth estimates have definitely come in. But the point is there is still growth. In 2008, oil demand went down 3 million barrels a day and we saw a real drop in demand. Yet when we look at a number of share prices in the sector, we've seen 50, 60 percent drops in a lot of the equities that we look at, even some high-quality ones. They seem to be pricing in an '08-like meltdown which we don't see, certainly not as our base case scenario.

As we look across individual commodities, we see some similar conclusions. Gold, for example, has pulled back from its recent highs reached about a month ago. Currently trading at about \$1,675, it's down 6 or 7 percent from the highs of about a month ago. But when we look at the macro backdrop for gold, which we've talked about many times, i.e., easy monetary policy around the world, what are central banks and governments going to do? What is Europe going to do for that matter? Frankly, they're going to print more money to help get out of their situation. When you consider historically how countries or governments get out of high-debt situations, especially some of the extreme situations that we see in certain countries today, there are only two real solutions: default or inflation. While we don't expect a lot of countries will default, this is quite likely the outcome we will see in Greece. We expect more governments would much rather print money, devalue their currencies and inflate themselves out of the debt situation because paying back levels of debt once you've devalued your currency is much less painful. It is the easy way out of a high-debt situation and looking at history, governments and central bankers generally will choose the easy way out if there's one available to them. This environment is positive for hard assets and gold in particular.

While we certainly don't consider ourselves to be 'gold bug', when we look at the macro economic backdrop today and what it means for paper currencies and hard assets, we think the direction is up for gold. With respect to demand, for the first time in 12 years, central banks were net buyers of gold and that continues today. Of note is the fact that many of these net buyers have been emerging markets including Mexico, Thailand and along with continued buying in China.

Switching to supply, despite 10 years of rising gold prices and a quadrupling of the gold price, mine supply is flat and this just goes to the backdrop of a number of commodities, the supply issue. We feel demand for commodities gets probably an undue amount of attention. Yes, demand has been strong. Yes, demand has been more focused on China and emerging market countries, but you're really talking about the fact that supply has largely been unable to keep pace. The reality remains that the big easy stuff has been found and it doesn't mean we've run out of oil, it doesn't mean we've run out of copper, but it means the big, cheap, easy stuff has been found. Now we're going after smaller deposits in deeper places at the bottom of the ocean. It takes higher prices to bring these deposits to market whether you're talking about copper or whether you're talking about gold or whether you're talking about oil.

We often get asked about the bubble debate and we continue to argue that gold is in a bull market but far from a bubble. Whether you look at inflation-adjusted terms, whether you look at total returns versus historical bubbles, we don't see gold as a bubble. We do, however, see gold as a bull market, for very good reasons.

Looking at some of the industrial commodities such as oil, we've said for a long time that it is an \$80 to \$100 range commodity. In extremes, you'll get short periods of time where you could go above and below that. We're certainly closer to the lower end of the range right now at \$85 oil, but most companies do just fine at \$85 oil. In fact, we prefer an \$85 environment because it's a price level where most decent oil companies can make good returns on their projects and yet it's not so high that it impacts global growth. Oil is one of those strange commodities because it is still so integral to the world economy where if the price gets too high, oil can cause its own recession. I would say that's not true of very many commodities, but it is true in oil and I think the \$80/\$90/\$100 range is a much more appropriate level for the oil price. So at \$85 oil, we are finding plenty of good companies to invest in. As I mentioned earlier, we expect that oil demand is still going to be up this year, just shy of about a million barrels per day despite the slowdown we're seeing in the western economies.

We've been relatively bearish on natural gas as a commodity, at least in North America – it's an important distinction – for several years now. We remain relatively bearish on natural gas, simply meaning we don't see a lot of near-term upside in the price. Having said that, some of the best performers in the energy space have been natural gas stocks, despite the fact that the commodity has been relatively flat. We have seen an entire repositioning of the North American gas market that is still underway and we would argue is still in the relatively early stages. The first stage was new horizontal drilling technology that let companies get more gas out of the ground quicker. The second stage was adding a significant amount of new reserves because of that drilling and the third phase will be now that we've found all this resource, how do we get a market for it? That part is underway right now. Part of that is going to be for the first time really in history, that North America will become a large-scale natural gas exporter and we think Canada will be at the forefront of that. They're working right now on a few different projects on the West Coast – Kitimat, BC likely to be the first one. It's going to mean that Canada and Canadian gas companies can sell more volume at a better price ultimately than they do today. It's still a few years away before we see that project come to fruition, but the point is this entire repositioning of the North American gas market still has several years to run. We expect to find several opportunities as a result.

The price of copper has come off from the \$4.00 handle to \$3.25. We don't know a single company that doesn't make good returns at \$3.25 for copper. You could almost argue the price is still too high in copper as opposed to too low. Do we prefer \$4.00 over \$3.00? Absolutely. But at \$3.00, copper companies are still making significant amounts of money and these are good, real returns all-in, not just cash returns. You've got to be a little bit selective in terms of which companies you own – you can't own every single copper miner out there but there are definitely opportunities as a result. As always, we continue to invest in good projects and good management teams.

If we consider fundamentals over the last several months, oil inventories around the world have been falling, copper inventories around the world have been falling, cotton inventories have been falling. For a number of these commodities, the fundamentals are still very strong. Near-term, many of the traders are out and some of the quick money has come out. We think that actually presents a good entry point for those sitting on cash or looking to reposition portfolios.

A few months ago, we had raised cash (4 to 5 percent range) for some of our portfolios and we've now started to redeploy this cash. We are finding you don't have to look for high-risk junior explorers to find good values in the market. Even in the gold market, we are seeing gold stocks trading at about a \$500 discount to the spot price of gold. From a valuation perspective, these are levels that we haven't seen in 10 years in this space. To conclude, while the headline risk is high and has a lot of people running for cover, we're spending our time looking for opportunities and are putting cash into the market at these levels.

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