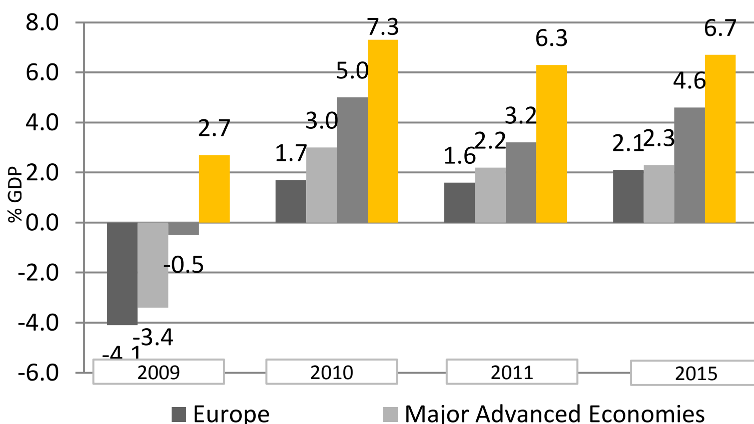
AGF EMERGING MARKETS - WHERE IN THE WORLD IS GROWTH?

As sovereign debt and growth concerns continue to dominate global market sentiment, investors may be challenged to find new growth opportunities. But even as the developed markets of Europe and the U.S. struggle to achieve growth under restrictive austerity measures and rising debt burdens, consensus opinion favours Emerging Markets (EM) as arguably the only source of growth for the global economy in the next few years.

But as past experience has shown, equity market performance does not necessarily reflect economic reality. On a year-to-date basis, the MSCI Emerging Markets Index benchmark returned -11.3% (in U.S. dollar terms, as of October 31, 2011), compared to the MSCI Developed World Index at -2.7%, including Europe at -7.3% and the U.S. at +1.31%[1]. Could this simply be evidence of past perceptions of EM economies as commodity-driven exporters dependent on global growth? Are investors discounting the positive economic fundamentals and strengthening growth prospects in EM?

Growth in EM Continues to Outpace Other Regions



Source: IMF, World Economic Outlook, September 2011; Note 2011 and 2015 are estimates only

While growth rates have been revised lower amid recent monetary tightening and declining global economic growth prospects, the long-term growth story remains compelling in emerging markets. Earlier fears of another worldwide recession appear to be unwarranted. China, the largest contributor to global growth in the post-financial crisis period, appears on track to grow by at least 8.0 to 8.5% annually, down from 10% last year[2], but certainly a respectable pace. Robust domestic conditions in Brazil led to a record surplus in tax revenue last year that exceeded estimates by over US$6.25 billion[3], allowing the country to lower interest rates. Countries like Turkey and Indonesia have also started to ease borrowing costs to offset external weakness. Additionally, while Europe, the U.S. and Japan each face challenges to growth from fiscal retrenchment, monetary policies overall remain accommodative with interest rates at historically low levels. The primary inflationary concerns now centre around borrowing costs, as spikes in bond yields in Italy, Spain and France have been a reflection of increased risk aversion.

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[1] Source: AGF Portfolio Analytics as at October 31, 2011

[2] Credit Suisse, September 2011

[3] The Economist, September 2011

Valuation - the Price for Growth Just Got Cheaper

Recent underperformance of EM equities has resulted in compelling valuations for investors seeking an attractive entry point to increase exposure. Driven primarily by fear and uncertainty rather than an actual deterioration in fundamentals, outflows from EM are at almost -18% of total assets, compared to the historic average of -16%. However, this outflow is nowhere near the almost -40% reached in early 2009.[4] Assuming that this could be a sign of capitulation, the stage may be set for a sharp recovery as we have seen in 2009, when prices ultimately caught up with fundamentals.

Equity Ratios by Region

	P/E	P/fwd E	P/CE	P/BV	ROE	DIV YIELD
Canada	**14.6**	**11.1**	**8.4**	**1.8**	**12.0**	**2.8**
MSCI World	12.2	9.8	7.3	1.5	12.3	3.1
North America	12.9	10.1	8.2	1.9	14.3	2.4
Europe	10.3	8.7	6.3	1.3	12.6	4.4
Asia Pacific ex-Japan	10.8	9.6	6.9	1.5	14.1	3.0
Latin America	10.4	9.1	7.0	1.6	15.3	3.1
Emerging Markets	**10.2**	**8.6**	**6.5**	**1.6**	**15.2**	**3.0**

Source: AGF Portfolio Analytics, Bloomberg as of Sept 30, 2011.

On a relative basis, EM is trading at a 16% discount to the world average on a P/E basis, and a 12% discount on a forward P/E basis. Is there a credible justification for current EM multiples trading at the same levels as Europe, given prevailing regional sovereign debt issues that remain unresolved? We believe that there is as EM companies offer 19% higher return on equity, and a comparable dividend yield. Looking to the past as a guide, historic and forward price earnings and price-to-book multiples are below five and ten year averages, and almost 40% below peak levels.[5]

The Impact and Outlook of Currency

Currency devaluation has been a key factor in the recent underperformance of EM (when considered in U.S. dollar terms), but we believe this is a result of short-term risk aversion and a flight to the relative safety of the U.S. dollar rather than a true deterioration in fundamentals. Declines in some major EM currencies reached almost 40% this past year, even as sovereign debt ratings are being upgraded in countries like Brazil and Turkey. It is estimated that every 10% rise in the U.S. dollar equates to a 4% relative underperformance for EM equities.[6]

[4] EPFR, Credit Suisse Research, as of October 2011
[5] Bloomberg, as of September 30, 2011
[6] Thomson Reuters, Credit Suisse Research, as of October 2011

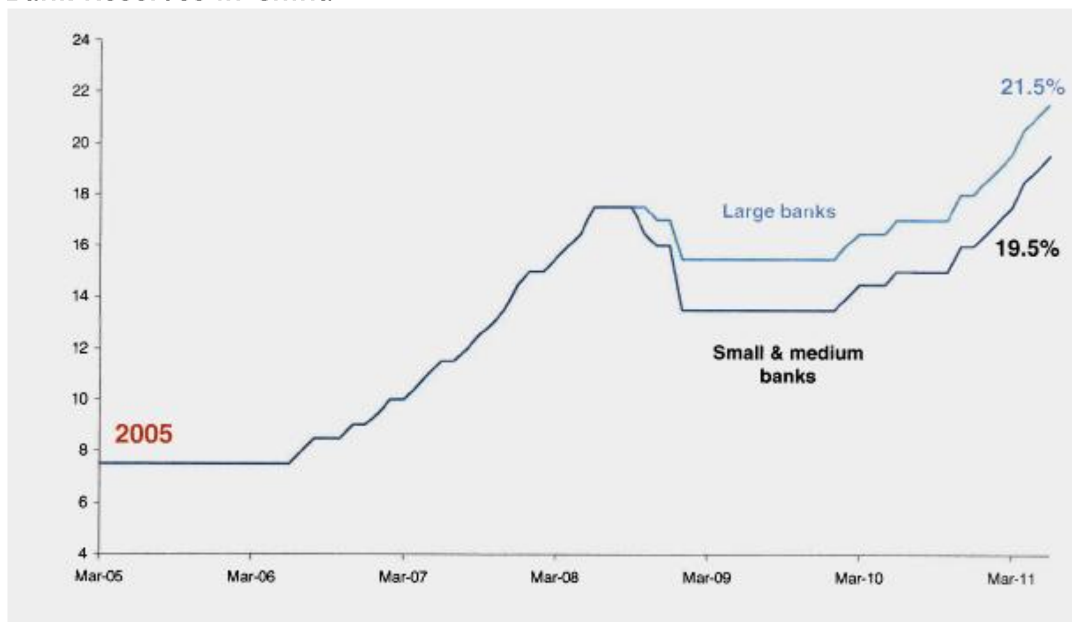
The long-term support for EM currencies comes from record high currency reserves. Emerging market countries hold nearly 80% of total government foreign reserves, yet only account for 17% of all government debt. China alone is sitting on official reserves of over US$3 trillion.[7]

A Word on China, and Why China Matters

China recently announced an easing of the bank reserve requirement ratio for its lenders for the first time since 2008 by 50 basis points.[8] Authorities in China have demonstrated the will and the ability to be extremely vigilant in preserving growth in the last few years, and we expect this to continue.

When inflationary pressures were mounting from the massive stimulus injection of 2008, the Chinese government used a multi-pronged approach to curb inflation with the use of interest-rate hikes, credit restrictions, open-market operations, and indirect acceleration of renminbi appreciation. Chinese Bank reserves have tripled since 2005 to nearly US$3 trillion, which is a de-facto tightening in the economy (see below).[9]

Bank Reserves in China



Source: JPMorgan, 2nd Quarter 2011

Earlier fears of a hard landing for China have proven to be unfounded. Urban fixed asset investment has moderated to 24.9% year over year in September 2011, while investment growth in primary industries such as; state owned construction and real estate have risen 25.5% year over year.[10] Although real estate investment growth has decelerated, it remains at 32.0% year over year, and investment for projects under construction remain robust at 19.8% YTD.[11]

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[7] Thomson Reuters, Credit Suisse Research, as of October 2011
[8] Bloomberg, as of November 30, 2011
[9] JP Morgan, 2nd quarter 2011
[10] Morgan Stanley, October 2011
[11] Morgan Stanley, October 2011

Retail sales growth has also continued to surprise on the upside with over 17% growth year over year, while total exports expanded by 16% in October from a year earlier.[12]

Now as global growth concerns persist, China is in the enviable position of having the ability to provide the necessary stimulus. Outstanding loans to small and medium-sized enterprises, where the pain of credit restrictions have been most pronounced, has grown by 29.3% and 17.8% respectively last year, much faster than to large companies.[13] As in any rapidly growing economy, there are some imbalances that have emerged and need to be addressed, such as local government debt and an imbalanced property market, but policymakers are taking measured steps to deal with these issues.

The 12th five-year plan introduced earlier this year aims to offset external growth concerns by focusing on the internal economy, driving up domestic consumption and tapping into the massive internal savings of its citizens, at almost 50% of GDP. Social welfare spending on health and education will free up disposable income, and almost 36 million new units of social housing over the next five years will ensure that workers will be able to live in areas where employment is available.[14]

Our Investment Approach

At AGF, our global equity research team and Emerging Markets mandate has generated industry recognition and significant asset growth since 2003. Our disciplined investment approach has enabled us to achieve a track record that captures upside potential and manages volatility risk. We focus on the concept of EVA (Economic Value Added), which we believe leads to better quality businesses that have demonstrated a strong track record of positive returns in excess of the cost of capital (minimum Cash Flow Return on Investment (CFROI) of at least 10%).

We only invest in companies that meet our minimum liquidity and capitalization standards, so that we can continue to function in challenging market conditions. We strive to be conservative in all of the assumptions used in our price models when determining intrinsic value estimates and price targets. We will only invest in a company following detailed qualitative and quantitative fundamental analysis that includes access to management in order to gain a complete understanding of a potential investment and prospects for future growth.

The commentaries contained herein are provided as a general source of information based on information available as of December 2011 and should not be considered as personal investment advice or an offer or solicitation to buy and/or sell securities. Every effort has been made to ensure accuracy in these commentaries at the time of publication, however accuracy cannot be guaranteed. Market conditions may change and the manager accepts no responsibility for individual investment decisions arising from the use or reliance on the information contained herein.

[12] Morgan Stanley, October 2011 and BCA Research – China Investment Strategy, November 2011

[13] BCA Research, October 2011

[14] BCA Research, October 2011