

Global Commentaries

Quarterly Outlook and Positioning 2012

April 2012

Asia Pacific ex-Japan

Asia Pacific ex-Japan markets rose strongly over the first quarter, outperforming World Markets. Investor sentiment improved as fears receded about the debt crisis in the Eurozone and as there were signs that the US economy may be turning the corner. For all the optimism, we remain concerned that markets are still held up by accommodative monetary policy (printing money) in the West and that the eventual removal of this stimulus will bring a reality-check in Asia and elsewhere.

Political concerns

Politics in both India and China appear increasingly fragile. In India, the governing Congress Party struggled in recent state elections. Historically it has responded by throwing money at the electorate, but with weak government finances this may prove difficult. In China, Bo Xilai's dismissal as Chongqing Communist Party Secretary is a reminder that we ought not to take Chinese political stability for granted.

Long-term focus on domestic consumption

Interestingly in both India and China the concern appears to have shifted from inflation to growth, as evidenced by recent monetary easing. In China we continue to question the widely held belief that the government is in control and can engineer a pain-free slowdown in the economy and would not be surprised to see turbulence down the line. Longer term we remain more positive, and continue to focus on the theme of domestic consumption, which we believe has bright prospects.

Defensively positioned

With the slowdown resulting from debt levels in the West countered by inflationary government policies, the outlook for the Region still depends largely on outside influences. With such opposing forces, preservation of capital should remain the focus and hence our portfolio remains very defensively positioned focusing on companies with pricing power, strong sustainable cash flows and growing dividend yields.

Global Emerging Markets

Emerging Markets gained strongly over the first quarter, along with World Markets, as risk appetite returned. Worries surrounding the Eurozone debt crisis eased as the European Central Bank extended lending to the banking sector late in 2011 and better-than-expected economic figures in the US suggested a recovery.

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Risks on the horizon

Despite rising markets there are still many risks on the horizon and as a result we remain cautious. A visit to Asia has made us concerned that 'private banking' in the region could be the next banana skin for global banks looking for new sources of revenue. The drive to increase income from fees could potentially lead to a mis-selling of products.

We question if the Chinese banking system – at the government's orders – really can or should channel depositors' money towards capital spending in the way it has done in the last 10 years. A continuation of Chinese investment and capital expenditure growth is questionable even if Chinese consumers continue to be better off in the medium-term.

While we have little direct exposure to mining companies in our Global Emerging Market (GEM) funds, we have to recognise that commodity producing countries like Brazil and South Africa are at risk because their governments are likely to base spending plans on the expectation of high commodity prices.

Focus on brand power

We continue to be sceptical that developed world authorities can solve the excess debt situation with more debt. A world of slow growth and rising costs strikes us as a difficult one in which to consistently raise profits/cash flows, as many businesses have in recent years. We believe that companies with strong brands often stand the best chance under such circumstances. In GEM, many of these companies look fully valued whereas many global multinationals with large and growing GEM businesses remain acceptably priced.

China

The Chinese equity market rose with global markets over the first quarter of 2012 as concerns eased about the sovereign debt crisis in the eurozone and investor appetite for risk increased. Sentiment was also boosted as China cut the amount of reserves that banks need to hold.

A political year

2012 will be an important year in Chinese politics with a change of leadership in November. Although there have been indications of infighting suggested by the sacking of Bo Xilai, we do not expect any significant change in policy as a result. The government is likely to remain focused on boosting consumption, reducing the reliance on investment and maintaining social stability.

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Banking concerns

The health of the Chinese banking sector continues to be a concern following excessive government-directed lending to boost the economy after the global financial crisis. We expect this issue will continue to be a gradual drag on the market rather than coming to a head given that banks and corporate borrowers are both owned by the state.

Cautiously positioned

At a company level we will continue to pay close attention to issues such as financial strength, corporate governance and management awareness of risk. As always, we remain focused on valuations, especially when it comes to popular sectors of the market such as consumer stocks. We are also concerned about earnings uncertainty arising from a slowing economy in China.

In our portfolios we are cautiously positioned, preferring companies exposed to consumption rather than investment and focused on those which are cash-generative and have strong management.

Global Agribusiness

Historically low grain stocks

We remain positive on the medium and long-term fundamentals driving the agricultural sector. Companies in the sector have solid cash generation capability, strong balance sheets and production growth opportunities. Demand growth for soft commodities will be driven by developing countries such as China and India, while soft commodity prices should be supported by historically-low grain inventories. It will require several years of record grain crops to restore global inventory balances to more comfortable levels.

Booming fertilizer demand

During the second quarter, agribusiness companies will release first-quarter earnings, when statements will provide a valuable indication of the outlook. Projections suggest that the US will plant its largest corn crop since 1937 at the expense of soybean production, due to the attractive margins corn is expected to generate. A large corn crop is a positive prospect for the application of all three fertilizer nutrients (potash, phosphate and nitrogen), as well as demand for seed.

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Quality low-cost producers

We continue to monitor global issues such as the lingering European debt crisis and potential geopolitical unrest in the Middle East. Within our own portfolios, positioning remains skewed towards agricultural input suppliers, like seeds and fertilizers, as current commodity prices are generating high incomes for farmers. We remain focused on investing in quality companies that are growing volumes and are positioned at the low-end of the cost curve.

Global Equities

Global equity markets rallied significantly over the last six months, as the downside risks around the two issues that were weighing on them – the eurozone debt crisis and global growth – abated. This reduction in risk appears to be priced into markets.

The US drives recovery

The global recovery looks underway, with financial market confidence returning on the back of supportive monetary policy. The US is emerging as a driver of world economic growth helped by plentiful cheap energy (shale gas), and of course, continued stimulus measures. The weaker Yen creates potential for Japan's export-led economy.

Not out of the woods yet

Rebalancing remains a key theme, with intense government expenditure cuts continuing in Europe, and China shifting from investment-led to consumption-led expansion. The Eurozone's problems remain serious and upcoming elections have the potential to unsettle markets. Emerging markets continue to grow but at an uncertain rate, as evidenced by conflicting data from China.

Company health is positive

While further volatility may well lie around the corner, companies are strongly capitalised, generating free cashflows and often supported by attractive dividends. Equity valuations appear favourable, especially relative to other asset classes.

Focus on 'Competitive Dynamics'

No matter what the economic environment, there will still be winners and losers at the corporate level. Our job is to find the winners – companies with strong 'Competitive Dynamics'. As always we continue to focus on individual companies rather than taking views on sectors or markets.

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Global Listed Infrastructure

A positive backdrop

In March, four members of our team who were visiting companies across the globe, brought back consistently upbeat comments from management in the US, UK, Europe and Latin America.

European management teams report that demand has held up better-than-expected, despite the region's economic and sovereign issues. Infrastructure companies are continuing to benefit from structural growth (reinvestment in ageing networks, government privatisation and mobile data usage) and the economic recovery. In addition, slow and steady growth is underpinned by the essential nature of infrastructure assets and ongoing investment.

Improving dividends

Recently, we have seen another positive trend as the market rewarded companies that increased dividends. Vopak, SES, Vinci, American Tower and Corrections Corporation of America all rallied as investors sought the visibility of growing dividends. In our view, these dividend increases highlight the strong balance sheets and robust business models across the sector. We expect this trend to continue in the months ahead.

Attractive assets for sale

Looking ahead, we expect financially distressed governments in various parts of the world to continue to divest assets in 2012, including highly valuable infrastructure. This will occur in several forms, including sell-downs of stakes in existing listed infrastructure companies, sales of assets to unlisted or listed operators, privatisations via initial public offerings (IPOs) and unwinding of cross shareholdings. The new governments in southern Europe are already underway in this process, with Portugal the most advanced, and we expect Italy and Spain to join the asset sell-off later this year.

Global Listed Property

Global listed property markets rose strongly over the first quarter as risk appetite increased. However, this positive sentiment had limited influence on real estate markets which usually lag the economy. With rental growth limited and banks reluctant to provide finance, real estate markets were generally sluggish. On the positive side, development pipelines are limited and in some markets rents are increasing slightly.

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Mixed picture in Europe

Despite the crisis in the eurozone, the picture across Europe continues to be mixed. Demand for German residential property and all sectors in Switzerland remains high, although city markets like Brussels and Amsterdam are under pressure. In the UK, London is in relatively good health, although demand is slipping in the office market because of job losses in the financial sector and the available space is increasing slightly.

Improvement in the US

The outlook is improving in the US with apartments one of the best sectors because of strong rental demand and shopping centres focused on higher-end tenants performing better. China performed well as concerns about oversupply in the residential market and government tightening measures were priced in by investors.

In our portfolios, we are overweight in Australia and Brazil and underweight Japan, Europe and the US. At a stock level we are particularly positive about the prospects for companies like Simon Property (US), Mirvac Group (Australia) and Digital Realty Trust (US).

Positive long-term opportunities

We believe that the asset class lacks a catalyst for strong performance at the moment because of concerns about the outlook for the global economy, although the environment is improving in Asia ex-China and in the US. Due to an improving picture, we believe that listed property markets are marginally attractive on a valuation basis following a good start in 2012. They do, however, offer positive opportunities for the long-term investor.

Global Resources

Western trade sanctions against Iran are expected to continue to support oil prices in the coming months, despite assurances from Saudi Arabia, the world's top exporter, that it will make up for any shortfall. Higher oil prices may impact the fragile global economic recovery and is a large cost in mining operations.

New tax in Australia

In Australia, legislation was finally passed through the Senate to introduce the Minerals Resources Rent Tax after a drawn-out battle with mining companies. The Senate has called on the Australian Government to release a summary of its legal advice to counteract industry concerns that the tax is unconstitutional. The tax is expected to take effect from 1 July 2012.

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M&A activity

Merger and acquisition activity looks set to continue in the sector. Commodities trader Glencore's \$90bn takeover of mining group Xstrata faces European Commission antitrust scrutiny in a process that could take many months. Meanwhile, large diversified energy company Royal Dutch Shell has made a \$1.6bn bid for Mozambique-focused Cove Energy.

Long-term focus on emerging markets

Although there are signs that investor confidence in the global economy is improving, geopolitical concerns in the Middle East and the ongoing debate about China's economic growth are likely to continue to cause volatility in mining and energy company shares and the underlying commodities. Overall, resource company business strategies stress the decline of the importance of the Western economies and the continued growth of emerging markets, led by China, even if a temporary slowdown materialises.

India

The Indian market rebounded strongly in the first quarter, strengthened in part by the broader global upswing in sentiment. Investors also drew some comfort from a slowdown in inflation and attendant hope of a relaxation of monetary policy. Indeed, the Reserve Bank of India cut interest rates for the first time in three years in April, signalling a shift in concerns from inflation to growth.

Running out of steam on reform

Importantly, the government has kept dragging its feet over critical economic reforms, causing much consternation in the business community. A much-needed overhaul of the tax system and trimming of the government's enormous fuel subsidies are needed. Discouragingly, the recently passed budget contained numerous business-hostile moves, such as a retrospective tax that predictably has unnerved businesses foreign and local.

Political worries

As far as politics are concerned the picture is messy to say the least, with efforts to instigate change thwarted by anti-reformist members of the coalition government. The rifts within the ruling Congress Party are apparent and its popularity clearly under stress as evidenced by the recent electoral defeat in Uttar Pradesh, India's most populous state. While we should not jump to conclusions, it is far from unthinkable that this prompts even more wasteful 'pro-poor' spending to bring disgruntled voters back on board.

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Focus on cash-generative companies

Governance problems remain rife in India, and as we have highlighted before, this narrows the pool of companies that we can invest in. We actively avoid businesses that are heavily intertwined with the government as this more often than not is a sign of murky dealings and an unfair competitive advantage. For all the risks, our long-term view on India remains highly sanguine and we will continue to seek out stable and cash-generative companies that pass our quality criteria.

Latin America

Latin American markets rose strongly over the first quarter, outperforming World markets. Risk appetite was strong on receding fears about the debt crisis in the Eurozone and recovery signs in the US. Except for Argentina, all markets gained significantly.

Our long-held views on Latin America have not changed. We continue to identify good quality companies, but valuations are in many instances too high to make acceptable long-term returns from owning them. We are concerned about the region's significant dependence on commodity exports to China, which makes it vulnerable to a slowdown in investment and capital spending there. Our Latin American funds have little direct exposure to mining firms, but the broader economic dependence remains.

Cautious on Argentina

We have been particularly cautious towards companies in Argentina although recent falls tempt us to buy in moderation as the risks are now more clearly reflected in some valuations than they have been for some time. Unpredictable government policy is rarely confined to the likes of Argentina as shareholders in some of the region's largest resources companies will testify in the last 5 years. We are particularly concerned about the direction of government involvement in the Brazilian economy which seems to be expanding. We wonder if the Brazilian government is prepared to adapt its spending plans to an era beyond high commodity prices.

Increasing exposure in Chile

The Fund's holdings in Chile are now larger than that in Brazil as we have found a few well-run companies trading at acceptable valuation levels. Indeed, the Chilean government has perhaps the best record of any in honouring long-term agreements with the private sector.

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For further information

Graham Fox	Head of UK & European Wholesale	+44 (0)20 7332 6530	graham.fox@firststate.co.uk
Marc Bishop	Sales Director, Europe & Third Party Distribution	+44 (0)20 7332 6556	marc.bishop@firststate.co.uk
Carol Cunningham	Sales Director, North of England, Scotland & Ireland	+44 (0)1606 883064	carol.cunningham@firststate.co.uk
Tom Burton	Sales Manager, South of England, Channel Islands	+44 (0)20 7332 6559	tom.burton@firststate.co.uk
Eva von Sydow	Sales Director, Europe	+44 (0)20 7332 6832	eva.vonsydow@firststate.co.uk
Ben Steele	Business Development Associate	+44 (0)20 7332 6547	ben.steele@firststate.co.uk

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