CIO LETTER

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Separating Wheat from Chaff

Is the Story of Emerging Markets intact?

Giordano Lombardo
Group Chief Investment Officer

In our previous CIO Letter, back in April, we mentioned a number of factors that could weigh on the global economy and the financial markets in the next few years. We argued that the world has become more unstable after the crisis and that the reasons for this instability are not going to disappear any time soon.
Among these: the ballooning debt in the developed countries and the tireless money-printing by Central Banks possibly leading to the creation of further asset price bubbles; then growing income inequalities, unemployment and social tensions on the rise, increasing and sometimes unnecessary regulations.

We also argued that, notwithstanding these elements of instability, it makes sense to remain overweight equity markets, particularly in developed equity markets. The main reason? Better expected returns than for bonds. It is true that in a zero interest rate environment markets are mostly driven by liquidity, which also leads to higher price volatility, and in this sense they appear to be more risky. But is this really the source of risk we should be concerned about? We find that “true risk”, in the sense of likely capital impairment, is to be found more in overextended bond markets than in equities, which offer decent value in a medium to long-term time horizon. Provided that one can withstand the short-term spikes in volatility, of course.

We realize that, thanks to the liquidity injection by Central Banks, equity markets have, in a sense, “front loaded” the genuine improvement in the real economy which will be needed to sustain further equity market gains in the next few years. Therefore, it will be important to monitor the progress in the different areas of the global economic landscape in terms of macro outlook and the consequent pattern of corporate profits. It is our perception that the US economy has definitely improved on the private-sector front (job creation and housing investment) while Europe is slowly emerging from a recession.

On the macro front, two new important elements have surfaced in the recent period, i.e. the debate on the so called **tapering** of the Fed’s very loose current monetary stance, and the changing economic outlook in China. A lot of comments have been dedicated to the first turning point, i.e. tapering, and we do not have too much to add to the debate about its “time-line”, if not that we believe that the most important issue for investors is not whether tapering will start sooner rather than later, but what will happen to equity markets when interest rates will begin to rise, probably next year (on this issue, see our special analysis below).

On the fixed-income side, we believe that a flexible approach will be key, as we need to dynamically adjust the duration and credit exposures in order to exploit short-term cycles in rates and spreads, while being aware that the trend for interest rates from current levels has only one direction: up. Admittedly, the "mini turmoil" in bond markets in June did not surprise us too much, especially on the Emerging Markets (EM) bonds side, as we have extensively written in previous comments. Bond prices have sharply declined almost everywhere in that period, but we were able to lessen the adverse impact thanks to this flexible approach and notably with a reduced risk profile (in terms of duration and credit risk exposure).

Changes in China's economic policies may have profound implications for the global economy as well

What surprised us more was the abrupt change of direction of economic policy in China. This can have profound implications for EM and for the global economy as well in the months to come. The newly-appointed Chinese leadership appears more determined than their predecessors to accelerate the reforms to preserve the sustainability of growth in the long term, even tolerating lower growth rates in the short term.

From this point of view, the aggressive curbs on bank lending by China's central bank (People's Bank of China) in June have led to the so-called "SHIBOR crisis" (code-name for Shanghai's interbank rates) and caught markets off guard, highlighting a major risk facing the Chinese economy: how to correct an unbalanced growth fuelled by an excess of credit (China's outstanding total credit should reach 240% of GDP in 2013, up 60% in 5 years) by giving the right "signals" to the markets. The determination of the Chinese leaders to remove this source of imbalance, potentially a credit bubble, is not bad news for China's long-term outlook and for the overall global stability. However, we do not know how big the impact is going to be in terms of lower growth. We suspect it is not going to be negligible.

This will have ramifications for other emerging economies and for the global economy as well. In July, the IMF revised down its estimates on EM growth, expecting GDP to rise by a "modest" 5 % in 2013 and 5.5% in 2014, which is well below the last 10-year average of 6.5%. So the question is: will a better outlook for developed countries be enough to offset a more subdued growth in EM?

Given the importance of the Chinese economy and of EM for the global economic picture, we believe that the spill-over effects will not be modest, and that we may be entering a phase of lower global growth. Furthermore, a Chinese economy growing at a slower pace and with more reliance on its consumer sector will also change the mix of countries, sectors and companies benefiting or losing from the Chinese slowdown. On the winning side we may find global producers of consumer products and service providers, for example, whereas producers of commodities and intermediate products may find themselves on the losing side. This means a lot of work and a lot of investment opportunities for our analysts and stock pickers!

Our global asset allocation has scaled down the exposure to Emerging Markets, cutting first bonds and then equities

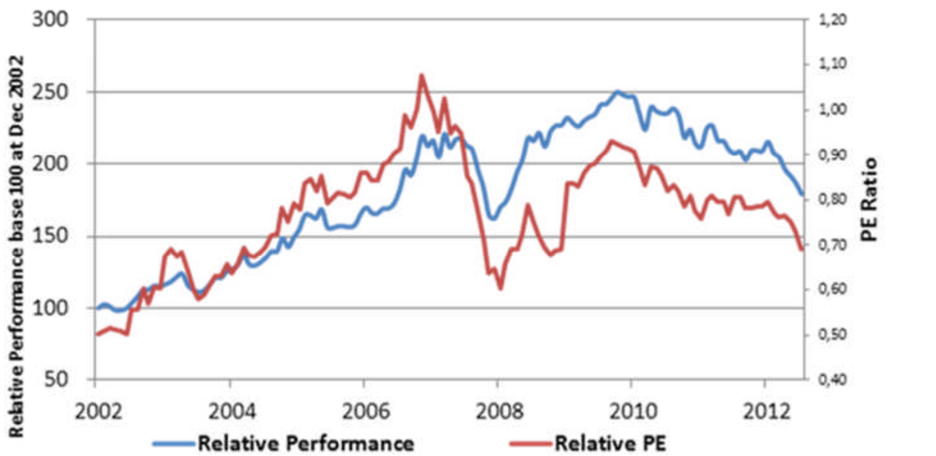
In terms of our **global asset allocation**, during the second quarter we progressively reduced our exposure to EM and EM-related asset classes, first on the bond side, then in equities and commodities as well, while rebalancing the risk towards developed countries, notably to US and Japanese equities. We continue to prefer **European to US equities** as we believe that the latter are becoming fully valued in relation to expected earnings. We are not particularly concerned by the corporate earnings' trend in the US, which we expect to remain strong. However, based on the current valuation level it is hard to expect more than 6% or 7% nominal returns in the medium term, especially since any increase in expected interest rates may put a lid on the needed further rise in equity multiples (as we argue later on).

Macroeconomic variables are less important to EM than stock valuations based on expected earnings

The most difficult decision is related to EM. In the short term, the recent massive sell-off of EM equities is translating into more appealing valuations, both in absolute and relative terms and a rebound from current level is possible as a result. The main issue, though, is whether the slower than expected rate of growth in EM is fully reflected in prices, because otherwise we could expect further underperformance of EM stocks and bonds.

A basic argument to be made about EM is that the relationship between macro growth and market returns is not straightforward: in the last two years, structurally faster GDP growth in EM did not feed into a better relative performance of EM equities. The reason is that the better or worse performance has been more related to relative (and absolute) valuations compared to expected company earnings than to the rate of macroeconomic growth per se (see graph below).

Emerging Markets: Valuation Matters



Source: Bloomberg, as of 30 June 2013, MSCI World Index for Developed Markets, MSCI EM Index for Emerging Markets

For the time being, we prefer to remain underweight in EM bonds, which continue to appear richly valued, mainly based on the relatively low credit risk premium, while we would like to play EM equity opportunities on a "value" basis, trying to avoid those countries or sectors where fundamentals are still priced for perfection and concentrating instead on selected and attractive valuation stories.

Emerging Markets are far from being a homogeneous group, as large micro and macro differences allow for a selective approach

We have long argued that considering EM or even just the major countries' group (Brazil, Russia, India and China, or BRICs) as a homogenous investment case is a mistake. The macro and micro differences are large enough to allow for big decisions on country and sector selection, all the more so in a slowing-growth scenario for EM. For example, within the BRICs, China is not the only country facing macroeconomic challenges, as India and Brazil have been running large current account deficits, thus highlighting potential currency risks. Regarding China, the recent underperformance of Chinese equities is probably at an advanced stage, and this makes us relatively comfortable with our exposure there, well aware that the ability to invest in the right sectors and the right stocks within the country will remain crucial.

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Rising interest rates have not been detrimental for US equities, as the S&P500 index gained at the end of the last tightening cycles

Going back to the potential impact on equity markets of **rising interest rates** in the next 12-18 months, we have run an analysis of the factors driving interest rates up in the US and what their effects have been on the S&P500. We found out that in the last forty years, during periods of policy tightening and rising interest rates, inflation and unemployment have explained roughly 70% of the Federal Reserve's (FED) tightening moves. The analysis also shows that the FED has given much more importance to the inflation variable than to unemployment. The remaining 30% can be explained by a variety of factors, among them the banking system's condition, monetary aggregates, bank reserves, etc.
Focusing on the last 5 major tightening cycles and looking at the impact on the U.S. equity market, we see that the effect of interest tightening on the S&P500 has not been dramatic. Apart from the initial response (usually negative), the S&P500 was able to offset the initial setback – on average lasting 2 quarters (the worst case was 5 quarters in the 70's) and in all of the 5 cases that we surveyed it ended up scoring gains at the end of the tightening cycle (see table below) .

The five major Federal Reserve Tightening Phases (1975 - 2006)

Initial quarter	Final Quarter	Initial Fed Fund rate	Final Fed Fund rate	Δ Rate	Initial value S&P500	Final value S&P500	Total Gain	Max Index Drawdown
31/12/1975	31/03/1980	4,875	20	**15,125**	90,19	102,09	**13,2%**	**-8,4%**
30/09/1986	31/03/1989	5,875	9,75	**3,875**	231,32	294,87	**27,5%**	**-23,2%**
30/09/1993	30/06/1995	3	6	**3**	458,93	544,75	**18,7%**	**-4,4%**
31/12/1998	29/12/2000	4,75	6,5	**1,75**	1229,23	1320,28	**7,4%**	**-8,1%**
30/06/2003	29/06/2007	1	5,25	**4,25**	974,5	1503,35	**54,3%**	**-2,6%**

Source: Bloomberg, US Federal Reserve

The point we want to make with this analysis is that equities may be able to withstand a "good" increase in interest rates, which is led by expectations of improved economic prospects, as opposed to a "bad" increase, led by rising inflation expectations. What will happen this time? We do not see an immediate inflationary risk in the US, but the longer-term prospects are less certain and we will continue to monitor them carefully.

Giordano Lombardo
Group CIO

Important Information

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