



## FLASH REPORT

### *Emerging Markets Update*

During the past six years, emerging markets have moved from the problem child to the darling of global investors. Since the bottom of the market in September, 2002, the MSCI Emerging Markets Index is up over 380%. Emerging markets are now mainstream investments, with institutional investors increasing allocations to the asset class. In addition, many global mandates have invested in some of the larger emerging markets equities. Clearly, such increased investor interest must be the harbinger of sub-par emerging market returns going forward, right?

Not necessarily. Emerging equity markets have had extraordinary returns, but there are factors suggesting that these markets are still relatively attractive, even after their recent performance. These include:

- Emerging markets were coming off very low levels after severe declines from 1997 to 2002.
- Most emerging market governments have adopted some form of the “Washington Consensus” of flexible exchange rates, respect for property rights, fiscal discipline and similar measures.
- Rapid economic growth has translated into earnings for companies and increased shareholder value.

TABLE 1: EMERGING MARKETS 1998 TO 2007

	MSCI EM Index	
	12/97 - 12/02	12/02 - 12/07
GDP	3.6%	6.0%
Earnings Growth Rate	-17.7%	29.7%
Market Return	-4.6%	37.5%

Source: Factset. All numbers are annualized.

Point 3 is vital. Emerging markets have always held the potential of high economic growth. But during the most recent bull market, emerging market economies and companies have delivered on that potential. Table 1 shows the changes in the economic and market environments between 2002 and 2007. While price to earnings ratios (P/E) increased modestly during that time (see Table 2), GDP growth almost doubled and earnings growth increased more than 20%. The rally in emerging markets has been well justified by increasing economic and corporate success in developing nations.

This year, emerging markets have had a 10% retreat, modest by historical standards and relatively insignificant in the context of the rally that began in the 4th quarter of 2002. However, in our

TABLE 2: EMERGING MARKETS P/E

	MSCI EM Index	
	12/31/02	05/31/08
P/E	14.0	15.8

Source: Factset

opinion the recent decline has made emerging markets, in general, that much more attractive. Table 3 displays the changes in market returns and valuations since the beginning of the year. As expected, valuations have declined with the retreat in share prices. What is more important is the changes in certain countries. Also shown are returns and valuations for the larger countries in the Index. While overall performance for the Index has been modestly negative, declines in the larger countries, especially China and India have been much more severe. Valuations in these countries have declined as well, creating potential buying opportunities based purely on improving market valuations.

TABLE 3: EMERGING MARKETS VALUATIONS AND RETURNS

	P/E		Performance
	12/31/07	05/31/08	YTD to 6/13/08
Brazil	15.5	16.7	12.3
China	27.0	18.8	-25.0
India	32.7	22.0	-33.7
Russia	14.9	14.5	0.2
South Korea	13.2	13.4	-15.1
Taiwan	16.4	15.2	-0.1
Emerging Markets (EM)	17.2	15.8	-9.1

Source: Factset

**DECOUPLING.** One key concern for emerging market investors is to what extent the economic slowdown in the developed world, especially the United States, will negatively affect emerging economies and stock markets. This concept is called *decoupling*. Whether markets have decoupled and to what extent has been recent fodder for dozens of research articles. We think the question is misplaced. Linkages among the larger economies of the world, including the major emerging market economies, are too well established to decouple. We believe a more apt metaphor is to view the global economy as a 747 airplane, with the four engines represented by the United State, Europe, Japan and the major emerging market economies. The major global economies are all clearly linked together, but the speed of the plane (and the turbulence of the trip) is dependent on the relative health of each of the engines.

The current economic slowdown in the US is likely to affect emerging markets. At least some portion of the current pullback in emerging stock markets is a reflection of lower expected growth.

However, we believe that investors' appetite for developing markets is likely to increase despite lower economic growth. This is because the differential growth rate between the developed and developing world is increasing. Most forecasts have the developing world slowing from a 6% GDP growth rate to 5-5.5% over the next few years. In contrast, developed world growth has slowed from approximately 2.5% to something less than 2%. "Emerging markets are now expected to grow at close to three times the GDP growth rate of more developed economies"<sup>1</sup>.

At Newgate, we believe that the recent rise in emerging market equity prices is a reflection of the rapid increase in economic growth and corporate profits in many emerging market countries. P/E expansion has been a very modest, secondary factor in this price rise, especially considering this year's decline. Given the prospects for economic growth relative to the developed world, as well as the relative stability in valuation ratios, we believe emerging markets will continue to be a valuable addition to a globally diversified portfolio. ♦

<sup>1</sup> Estimates taken from Goldman Sachs, World Bank and Consensus Economics

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