



## FLASH REPORT

### *Emerging Markets Update*

**T**he current crisis is unique in its effect on emerging markets. For the first time, emerging markets are more a victim of a global credit crisis than a root cause. Granted, the declines don't feel any different regardless of their cause. However, as investors, we must examine these root causes in order to make allocation decisions. We think it helps to focus on the market environment first, and then look at the fundamentals in emerging markets.

**MARKET FORCES.** It seems clear that markets are reacting violently to economic events. We avoid the term "irrationally." It is perfectly rational for investors to reduce exposure to economically sensitive areas as the extent of the global recession becomes clearer. However, there are obvious signs of markets moving too far, too fast, in all directions, and with an unprecedented velocity. Much of the volatility is coming from rapid selling by momentum driven investors, most notably hedge funds facing a combination of deleveraging and investor redemptions. Evidence for this is abundant, including a VIX level considered unreachable only a few months ago.

In the past few days, this deleveraging caused a sharp foreign exchange selloff, not only in emerging market currencies, but also in the Euro and the British Pound. The US dollar and Japanese Yen have been the net beneficiaries of this currency move. Has the market really decided that the USD is truly the best investment, given low interest rates, (negative after inflation) and a commitment by the government to leave on the printing press until they run out of ink? Or have T-bills become the instrument of choice to park cash? If you think it's the latter (and we do), then you must think that the corresponding selloff in riskier securities, especially non-dollar riskier securities, has been overdone. We think that emerging markets will be recipients of funds once investors start to put risk back into their portfolios – that the fundamentals are (or will be) compelling.

**FUNDAMENTALS.** Several fundamental forces favor emerging markets investment. The first is valuation. At less than 9 times earnings, trailing valuations in emerging markets are generally below 50% of their 10 year averages. China is now below 10 times earnings, remarkable for a country growing at over 8% per annum. And that is the important part, "growing" not "expected to grow." Taiwan is even more extreme. The Taiwanese market, due to its large economic reliance on higher valuation technology stocks, is now trading at just over 9 times earnings, a 2/3 discount to its 27 times average P/E ratio. The markets know that we are in a global recession, and are reasonably discounting future earnings. However, at any reasonable forecast for the future, even a substantial discount to current earnings, these markets are cheap.

The numbers become more extreme in terms of book value. Many countries, including Russia and Korea, are trading with book values near or below 1 time Price to Book. This latest crisis may have exposed a structural weakness in Russia's monetary systems, but Europe is still reliant on Russia for the better part of its energy needs. And it still maintains large budget surpluses, and is expected to add to them, even at current levels for oil and natural gas.

The other major support for emerging markets is their generally superior fiscal position. There are significant exceptions to this rule. The entire asset class is not necessarily in great shape, but many of the leading countries have very strong budget and trade surpluses. Principal among these is China, but Malaysia and Taiwan also have meaningful current account surpluses. Both Korea and Russia are also expected to add to their current account surplus, though this is somewhat dependent on the overall economy and, in Russia's case, energy prices. These countries all have the ability to stimulate their economies using fiscal reserves – in some cases, easier than in the US. The US resists government intervention in the economy, and the

notion of the government getting directly involved in the daily operations of banks is an anathema. In many emerging market countries, these actions are much less troubling, and therefore faster and easier to implement.

Overall, the major emerging market economies are likely to avoid having actual economic contraction, and are likely to experience growth in the 4-4.5% range on average. Some, notably China and India, will do better than average, and others, likely Mexico and the Eastern European markets, will do worse. We believe that actual GDP growth, combined with all time low valuations, will bring investors back to emerging markets once we get through this panic phase of the downturn.

Much of the core logic underpinning emerging market investments remains in place; ironically, some is even strengthened. Emerging markets still

have an active, and unleveraged, consumer base. They still have a commitment to infrastructure spending to modernize their economies. And they still have a highly energized workforce that looks to their own country, and to other emerging market countries, as a source of growth and opportunity.

At Newgate, we believe this economic crisis is fundamentally different from others in history. It will not be a question of a few months of pain (the average US recession only lasts 8 months) and then back to the races. The global deleveraging will take years, and the effects are impossible to predict with certainty. However, we do believe that one effect will be investors looking globally for both safety and value. The notion that the US is the global safe haven has been permanently dispelled. In this context, we think emerging markets will begin to shine. ♦

## MORGAN STANLEY CAPITAL INTERNATIONAL EMERGING MARKETS VALUATIONS 10/23/08

EM Index	MSCI EM Weight	# of Sec in Index	IBES Aggregates P/E		IBES EPS Growth		MSCI Current Trailing Multiples				
			2008E	2009E	2008E	2009E	P/E	PCE	P/Book	DY	ROE
<b>MSCI LatAm</b>	<b>20.8%</b>	<b>133</b>	<b>6.7x</b>	<b>5.7x</b>	<b>17.8%</b>	<b>17.2%</b>	<b>6.9x</b>	<b>4.4x</b>	<b>1.3x</b>	<b>4.7%</b>	<b>18.7%</b>
Brazil	12.8%	71	5.7x	4.8x	21.8%	19.3%	6.5x	4.2x	1.2x	5.0%	18.4%
Mexico	4.9%	27	8.9x	8.0x	3.1%	10.6%	7.4x	4.4x	1.5x	4.0%	20.6%
Chile	1.5%	17	13.7x	11.5x	15.9%	18.7%	13.5x	7.5x	1.5x	3.3%	11.4%
Argentina	0.4%	5	8.8x	12.4x	62.6%	5.1%	4.3x	3.1x	1.1x	3.5%	26.3%
Peru	0.5%	6	#N/A	9.8x	#N/A	15.5%	6.3x	5.1x	2.1x	8.9%	32.8%
<b>MSCI EM Asia</b>	<b>56.8%</b>	<b>482</b>	<b>9.5x</b>	<b>8.3x</b>	<b>-0.3%</b>	<b>14.1%</b>	<b>8.0x</b>	<b>4.8x</b>	<b>1.2x</b>	<b>4.7%</b>	<b>15.5%</b>
Korea	13.5%	94	9.1x	7.9x	-2.6%	15.8%	6.4x	4.2x	0.8x	3.5%	13.2%
Taiwan	12.4%	114	10.6x	9.7x	-24.7%	9.3%	8.0x	4.0x	1.1x	8.4%	14.4%
China	16.2%	101	8.9x	7.8x	13.1%	13.5%	8.3x	4.9x	1.4x	3.8%	17.5%
India	7.3%	61	10.9x	8.9x	9.7%	22.1%	10.5x	7.4x	2.1x	1.9%	20.1%
Malaysia	3.3%	43	10.7x	10.3x	-13.5%	3.8%	9.4x	7.0x	1.5x	4.0%	15.5%
Indonesia	1.8%	21	8.1x	6.3x	16.3%	29.0%	8.1x	5.0x	2.2x	5.7%	27.2%
Thailand	1.6%	26	6.9x	6.5x	111.3%	6.1%	8.1x	4.7x	1.2x	6.3%	14.2%
Philippines	0.6%	14	11.6x	10.2x	-2.8%	13.6%	10.4x	6.3x	1.7x	4.3%	16.5%
<b>MSCI EMEA</b>	<b>22.4%</b>	<b>173</b>	<b>5.7x</b>	<b>5.0x</b>	<b>17.3%</b>	<b>13.3%</b>	<b>5.4x</b>	<b>3.9x</b>	<b>1.0x</b>	<b>5.5%</b>	<b>18.8%</b>
Russia	6.5%	29	3.3x	3.0x	24.8%	7.9%	3.4x	2.5x	0.7x	4.2%	19.1%
South Africa	6.6%	42	8.5x	6.8x	13.7%	25.5%	7.3x	5.5x	1.4x	6.9%	18.8%
Israel	3.4%	22	11.1x	8.6x	10.7%	28.9%	12.3x	9.2x	1.7x	2.9%	13.7%
Poland	1.6%	22	6.6x	6.3x	-2.4%	4.8%	4.9x	2.4x	0.9x	8.6%	17.4%
Turkey	1.4%	27	5.2x	4.5x	6.3%	14.7%	3.5x	3.1x	0.7x	8.0%	21.5%
Hungary	0.6%	4	4.4x	4.6x	19.2%	-4.3%	3.3x	2.1x	0.8x	5.9%	23.4%
Egypt	0.8%	12	6.7x	6.0x	16.9%	12.4%	7.1x	4.9x	1.9x	5.3%	26.3%
Czech Republic	0.9%	6	10.2x	8.9x	14.5%	14.0%	9.2x	5.4x	1.8x	6.9%	19.5%
Morocco	0.6%	6	19.1x	15.9x	28.4%	7.1%	26.7x	16.2x	5.4x	3.1%	20.1%
<b>MSCI EM</b>	<b>NA</b>	<b>788</b>	<b>7.7x</b>	<b>6.7x</b>	<b>8.4%</b>	<b>14.5%</b>	<b>7.0x</b>	<b>4.5x</b>	<b>1.2x</b>	<b>4.9%</b>	<b>17.0%</b>
<b>MSCI World</b>	<b>NA</b>	<b>1,730</b>	<b>10.0x</b>	<b>8.7x</b>	<b>-2.0%</b>	<b>15.6%</b>	<b>10.2x</b>	<b>6.0x</b>	<b>1.4x</b>	<b>4.2%</b>	<b>13.8%</b>
<b>EAFE</b>	<b>NA</b>	<b>1,021</b>	<b>9.6x</b>	<b>8.5x</b>	<b>-4.5%</b>	<b>12.7%</b>	<b>8.4x</b>	<b>5.0x</b>	<b>1.2x</b>	<b>5.4%</b>	<b>14.1%</b>

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