



FLASH REPORT: EMERGING MARKETS

Emerging Markets and the Road to Recovery

As we have closed the books on an awful 2008, how are emerging markets positioned for recovery relative to other equity asset classes? After last year's decline, many asset classes appear cheap, but we believe that emerging markets offer investors a superior combination of growth prospects and extreme valuations on both a trailing and a forward basis.

LOOKING BACKWARD. We won't rehash what has been written about last year. Everyone knows the proximate cause of the market meltdown, and future generations can debate the effects, good or ill, of the various government interventions to stem the crisis. The psychological impact of the downturn has been severe. While hardly unreported, discussions of how investors will think about the markets over the next ten years have been reduced to articles like "Best 5 stocks for the next 6 months" and "Obamanomics." That is fine for CNBC viewers, yet serious investors need to think about the future not only of companies, but of the market itself.

Investing for the long term has come under scrutiny, if not derision. Volatility and the recent declines have erased years of gains from most major market indices. Emerging markets have been a notable exception. As Table 1 shows, returns on emerging markets investments have averaged over 9% per annum over the past ten years, contrasted with effectively flat returns for developed market indices. Returns have been augmented for investors

who rebalanced portfolios, withdrawing money after above-average years and adding money after relatively poor ones. If "buy and hold" investing works for any asset class, it would appear most advantageous for emerging markets.

Why have emerging markets done well as long term investments? Over time, stock markets are driven by the same factor – the participation of equity owners in the growth of corporate earnings, and by extension, the growth in their economies. Emerging market economies are growing faster than developed ones. More growth means higher returns. Anticipated growth rates for all markets have come down, but emerging markets are still expected to grow at a faster rate over the next five years than developed ones.

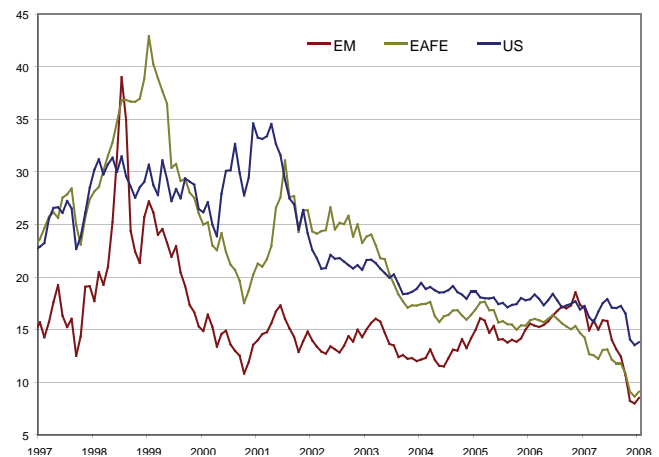
LOOKING FORWARD. The other factor driving markets forward is valuation, typically expressed by Price-to-Earnings (P/E) ratios. Abnormally low valuation metrics, often referred to as "trough valuations" often signal the approach of market bottoms. As Chart 1 shows, emerging markets are at 15 year low valuations, lower than they were

TABLE 1: ANNUALIZED PERFORMANCE AS OF 12/31/08

	S&P 500	MSCI EM	MSCI EAFE
3 year	-8.50	-4.61	-6.91
5 year	-1.97	8.01	2.10
10 year	-0.76	9.31	1.18

Source: Factset, Bloomberg

CHART 1: VALUATIONS AS OF 12/31/08



Source: Bloomberg

after the Asian currency crisis in 1997 and the Latin American debt crisis in 2002. These two emerging market declines were caused by flaws in the structure of emerging market economies – too much debt in a fixed exchange rate regime. Current valuations are lower, despite the superior economic position of many of the emerging markets.

It is also instructive to look at valuations from the emerging bull market in the past five years. While valuation ratios increased, they did not spike; in fact, P/E ratios never exceeded 20. Instead, the bull market was caused primarily by earnings growth and increasing expectations for earnings.

Expectations for future earnings are a vital component of stock market valuations. It's next year's earnings that often matters most, especially during periods of economic contraction. Table 2 shows valuations based on current and next year's expected earnings. Emerging markets are pricing in slightly negative earnings growth for all of 2009. This is in contrast to the developed markets, where analysts are still forecasting relatively modest growth. Can even predictions of flat growth be too optimistic? Of course. But after the recent losses, markets are still more focused on the negatives and are discounting prospects for recovery. Given the level of pessimism, even modest improvements in the global economy should boost equity markets.

ROAD TO RECOVERY. Emerging markets are not fundamentally different from developed ones. Just as all markets share the long term driver of corporate earnings, they are all sensitive to short term factors like liquidity, confidence and similar

measures of investor sentiment. The recent market drubbing has created highly negative sentiment with respect to all equity markets. Money has flooded US Treasury assets that now have all time low yields.

This excess investment in treasuries, estimated to be between 750 billion - 1 trillion dollars, will eventually find its way back into riskier investments. It is inconceivable that institutional investors will leave money in low yielding assets when they have to meet liabilities to retirees (for pensions) or minimum payouts (for foundations and endowments). They will be forced as a measure of fiduciary obligation to shift money out of assets with negative expected real return (cash and US treasuries) over the next 3-5 years.

Where will assets go? We can make a very strong case that emerging markets will receive a good look for the following reasons:

- Trough valuations
- Negative earnings environment already evident in estimates
- Low debt generally across much of the developing world (especially Asia)
- Fear of a weakening US dollar as a result of larger budget deficits.

None of this will guarantee that the declines of 2008 will be reversed any time soon. But at some point investors will have to return to focusing on fundamentals, not liquidity. When they do, we believe they will find emerging markets possessing a number of attributes not only positive in their own right, but in many ways superior to developed markets. ♦

TABLE 2: VALUATION COMPARISON 12/31/08

	MSCI Trailing P/E Multiples	IBES Aggregates P/E 2009E	IBES EPS Growth 2009E
MSCI EM	8.3	8.2	-0.2%
MSCI EAFE	8.9	9.1	4.4%
MSCI USA	13.2	11.3	3.3%

Source: Morgan Stanley Capital International (MSCI)