

## Emerging Markets – is the story over?

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**Even Harry Potter could not forecast the future and my crystal ball is no better than his – it will reveal only brief pictures, some of which should worry investors, and others that should reassure.**

My latest glance revealed these worries:

### Returns

The return in US dollars of the MSCI Emerging Markets Index for the calendar years 2002-2007 were +56%, +26%, +34%, +32% and +39%. It is true that some of this return was a consequence of a fall in the dollar but one does not have to be a died-in-the-wool contrarian for that return stream to ring alarm bells.

### Valuations

Investors have long been accustomed to emerging markets trading at valuation discounts to their developed counterparts. A comparison of aggregate index valuations shows that discount has all but disappeared.

Index	2008 PER	P/BV
MSCI World	14.2	2.1
MSCI USA	16.7	2.5
MSCI GEM	15.0	2.5
MSCI Asia	15.8	2.3

Source: Factset, MSCI

This is unusual, but not unheard of. Emerging markets have traded at higher ratings than developed ex-Japan in the past. Unfortunately, the subsequent de-rating was usually caused by sharp price falls rather than strong earnings growth.

### Concentration

Energy and materials now make up 36.3% of the benchmark (five years ago that proportion was less than 21%). Perhaps even more worrying for investors seeking to benefit from a structural improvement in emerging economies, is the concentration in those two sectors in the most liquid part of the market. Using a market capitalisation minimum of \$10bn as a proxy for high liquidity provides a sub-set of the global emerging markets universe of 67 stocks. Over 50% of this sub-set is involved in commodities or energy. Especially last year, it was these stocks that drove markets up. For those investors that believe that the commodity boom is a consequence of supply side shortages and/or global inflation and/or the \$250bn that has been invested in commodity index funds since 2003, then it is at least arguable that these stocks are not driven by the fundamentals of emerging economies.

My crystal ball then revealed some more positive factors:

### Fundamentals

Longer term structural trends of demographics, urbanisation and improved literacy are well embedded and unlikely to change. With some exceptions, market orientated economic policies and an acceptance of the benefits of globalisation and private enterprise are widespread. These trends will fuel economic growth at 2-3 times the level of developed economies for many years to come and our confidence in the ability of our companies to participate in that growth is strong.

### Earnings potential

Corporate profitability in emerging markets has beaten expectations in each of the last five years. Part of the reason for this is of course the commodity boom, but it is also true that more domestic orientated companies have done well. Improved corporate competence, better balance sheet management and booming demand have brought about a dramatic improvement in the ability of emerging companies to translate sales growth into profit growth. There is no sign of this changing. Short-term forecasts for emerging markets earnings are of limited value, but in the medium and longer term there seems little reason to doubt that aggregate emerging company earnings will grow substantially faster than those in developed markets, and they are still valued at parity. In other words, valuations are high on a historic basis but not when taking account of the long term growth prospects.

### Demand

Five years ago demand for emerging markets was largely confined to institutional investors and (at the top of the market) retail investors from the US and Japan. Now we are seeing new investors looking to enter these markets, partly because of a conviction that they are good long term investments and partly due to a desire to diversify away from the US dollar and the US stock market. Petro-dollars are increasingly being re-cycled into emerging economies. Sovereign wealth funds (\$6trillion and counting) and retail investors from Asia with their traditionally high savings ratios are joining the queue.

One day soon, the commodity boom will come to an end. When this happens, the commodity stocks and hence emerging market indices, will almost certainly suffer a fairly severe set-back. (By "soon" I really mean "in the next two years", so this comment has little current investment value). Investors who have piled into the mega-cap stocks will suffer most. This will not be the end of the emerging market story.

When we started Rexiter in 1997, I recall part of our "pitch" was that the combined value of the MSCI Emerging Markets Index was less than 5% of the world market capitalisation, but represented 85% of global population. Five years ago they were only a bit bigger than Exxon and Microsoft. As of today, they are 5 times bigger than those companies, but still, to mix my comparisons, China and India (population 2.5bn) are a smaller proportion of the MSCI Index than Switzerland (population 7.2m).

Fortunately, it is not within the scope of this article to forecast the returns from emerging markets over the next twelve months. I will stick my neck out so far as to say that in five years time, China and India will have overtaken Switzerland in the capitalisation race!

*Sources: Rexiter, Factset, MSCI*