



Monday, September 29, 2008

## FEATURES MAIN

# It's Time to Revisit Emerging Markets

By LESLIE P. NORTON

*Turbulent, yes. But they look cheap again -- and they're our future.*

**FOR THE BETTER PART OF A YEAR**, Ben Inker was worried about skyrocketing emerging-markets shares. Rising commodity prices, rampant global outsourcing and rapid industrialization had shoved valuations to big premiums over older, more stable markets like the U.S.

Inker, a bright Yale grad who oversees the asset-allocation division of money-manager Grantham Mayo Van Otterloo, finally threw in the towel in July, as the U.S. financial crisis worsened, European and Japanese economies appeared stalled, and commodities prices plunged. Jeremy Grantham, GMO's chairman, subsequently said the well-respected asset manager was "underweight" the bourses of the developing world, and that U.S. shares would produce greater returns.



Thomsa Michael Alleman

Pimco's Mohamed El-Erian: A U.S. financial-stabilization program should produce "an even sharper rally in emerging markets than U.S. equities."

Smart call: Brazil is off 23%, Mexico 13%, Russia 43%, China 16%, Korea 12%, versus a 3% decline for the U.S. since July.

**BUT JUST A FEW MONTHS LATER**, Inker and GMO are rethinking their stance. "They've fallen far worse than everybody else, and probably are once again cheap relative to the world's other equity markets," says Inker. "Life is surprisingly different."

Mohamed El-Erian, the emerging-markets expert who is now the co-chief-investment officer of Pimco, is even more optimistic. He cites the markets' superior growth and favorable wealth-dynamics, even though the U.S. financial crisis caused many fund managers to repatriate their capital from markets that, in hindsight, were probably too small and


narrow to accommodate the flows.

"Is there a cyclical case now for emerging markets? Yes there is," says El-Erian.

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If it finally comes together, Washington's financial-stabilization plan "is not only going to stop the rush out the door, but attract new interest. Technically, you'll see an even sharper rally in emerging markets than U.S. equities. I'd at this point be looking to buy the [MSCI Emerging Markets] index."

Even if the next rally doesn't quite look like the straight-up trajectory that troubled Inker, it holds the prospect of reversing recent losses based on strong -- but not as strong -- economic growth.

Virtually all of the experts *Barron's* checked with last week cautioned investors to steer clear of frontier markets like Pakistan, and to channel more funds toward either broad indexes or more robust economies like China's.

There are plenty of obstacles to help keep growth from getting out of control. Third-quarter results are likely to be a bloodbath for emerging-markets funds, which are down 22% quarter-to-date, and 33% so far this year -- something *Barron's* predicted last summer ("[Is the Bloom Off Emerging Markets?](#)," July 30, 2007).

As oil and other commodities collapsed, Asia outpaced Latin America in the third quarter. Investors yanked cash from funds focused on the developing world as the financial crisis worsened this month. "Appetite has dwindled, even as relative optimism about U.S. shares rises," says Michael Hartnett, the emerging-markets strategist for Merrill Lynch. "Global investors are being forced to sell anything they can't pronounce. You're starting to see distressed valuations," he says.

The jitters rose last week as Washington struggled over the terms for a bailout bill for Wall Street. In Hong Kong, false rumors about Bank of East Asia's solvency sent stocks plunging. The declines also disabused remaining fans who prized the funds for theoretically low correlation: In fact, they're 80% correlated with the Standard & Poor's 500. And as world markets sag, emerging markets fall right along with them.

**Table:** [Where Investors May Turn First](#)

One key fact to remember: This financial crisis didn't start in the developing world as so many did in the '90s -- Mexico's '94 peso devaluation, for example, or Thailand's '97 decoupling from the dollar, or Brazil's depreciation of its currency, the real, in '99.

Conditions in developing countries haven't been this good in years. They may be at their best since MSCI launched the index exactly 20 years ago. China, Malaysia, Taiwan and Russia are all building current account surpluses. Thanks to the boom in commodities, Brazil in January became a net creditor, and joined the ranks of investment grade sovereigns in the spring.

**THE SHARES' SUDDEN CHEAPNESS** and the growth in the developing world contrast with the tougher times Western economies face trying to squeeze out more growth Nobody knows how far the banking crisis will lower long-term growth rates for the big Group of Seven countries.

Yes, the emerging markets will be affected, too. The International Monetary Fund thinks growth in the developing world will slow to 7% this year, from 8% in '07. Analysts have been chopping earnings-growth estimates for the MSCI Emerging Markets index companies to 10.1% in '08 and 17.2% in '09. Morgan Stanley took its '08 forecast down to 5%, and thinks earnings will grow 7% at these companies in '09.

Antoine Van Agtmael, the investor who coined the term "emerging markets," thinks the group will still earn 12% to 15% this year. Last week, the MSCI index traded at 10.9 times trailing earnings -- its lowest valuation since October of 2001 and cheap even assuming a lower level of "normalized" earnings. In contrast, the S&P 500 trades at 23 times trailing earnings. A nearby list of the MSCI index's largest markets shows that for many bourses, earnings can take a decent haircut.

Thus, it makes sense to start building a position in a cheap sector where the long-term bullish case remains intact. David Fisher, chairman of Capital Group, recently said he expects 70% of the world's growth over the next two decades to come from the emerging markets. At the moment, they account for just 11% of the world's stock-market value, even though JPMorgan Chase reckons they'll account for 28% of the global economy next year. By contrast, the U.S. accounts for 40% of the world's stock-market value, but only a quarter of its economy.

The developing world's young populations and rising wealth will keep growth going for decades. "These attractive demographics will go through their life cycles -- consuming more, buying houses and raising families," says David Riedel, who steers Riedel Research, an emerging-markets equity analysis firm.

Here are some pointers *Barron's* got last week from keen observers of developing markets:

El-Erian of Pimco recommends buying an index fund. One is the [iShares MSCI Emerging Markets Index Fund](#) (ticker: EEM). And he thinks equities are cheaper than bonds. Last week, the JPMorgan EMBI-Plus index, the developing-markets bond benchmark, was just 367 basis points over comparable U.S. Treasuries, versus 1,000 points in the Asian economic crisis.

Russell Napier of CLSA Asia-Pacific Markets advises steering clear of heavily leveraged markets, "since whole societies on the planet will spend decades deleveraging," and recommends the following: "If the loan-to-deposit ratio is over 100%, there's a very high probability that the whole country will need to delever." The loan-to-deposit ratio in Hong Kong is 57.4%, in China, 65%; Indonesia, 72%; the Philippines, 73%; Malaysia, 74%, and Taiwan, 78%. The loan-to-deposit ratios in India, Korea and Thailand all exceed 100%.

One country to watch is China; its market was the first to fall sharply on a whiff of inflation. Just weeks after the Olympics ended, China cut interest rates for the first time in more than six years and reduced the reserve-requirement ratio for most banks, as slower growth led to a surprisingly large profit decline. Inflation fears seem to have eased.

Yet even the once-expensive Chinese A-shares, which previously traded at a premium of 100% to comparable Hong Kong traded H-shares that are widely available to foreigners, have sunk to a premium of 15%. Today, the MSCI China index trades at 13 times trailing earnings, its lowest level since January 2006.

Says Chen Zhao of BCA Research: "The market has dropped 70%, the economy is growing 10%, inflation is melting, and they're cutting rates." Riedel is a fan of [China Mobile](#) (CHL), which is posting fatter margins and revenue growth despite a 43% stock-price decline this year.

How about the rest of the BRICs (Brazil, Russia, India, China)?

Russia, which shut down its markets amidst the worst of the turmoil and moved to support stock prices, now trades at six times forward earnings; blue chip **Gazprom** (GAZP.Russia), at 206 rubles last week, trades at six times earnings. Still, it's subject to political risk: It collapsed after Russia attacked Georgia, then rebounded; the index is

also heavily weighted in energy.

Brazil, too, has been hard hit by the commodities slowdown. It trades at nine times forward earnings, although MSCI pegs long-term earnings growth at 15%. "We're looking for lower interest rates in Brazil in late '08, and I think it's oversold," says Geoff Dennis, the Latin American strategist at Citigroup. Morgan Stanley, meanwhile, moved Brazil to Overweight in its emerging-markets model portfolio, noting that valuations had halved since Brazil was upgraded to investment-grade. It recommends miner **Cia Vale do Rio Doce** (RIO), oil giant **Petrobras** (PBR), and one of the country's largest lenders **Unibanco** (UBB).

India likewise maintains a tough credit policy, and given its double-digit valuation, there are plenty of cheaper markets around. Still, India is chock-a-bloc with attractive companies. Tom Naughton of Sparx Asset Management in Hong Kong likes **HDFC Bank** (HDB), the mortgage company that's growing its loan book at a 25% clip with lots of room to expand, because India's mortgage to gross-domestic-product ratio is just 5%.

**TO REAL BARGAIN-HUNTERS**, India and China remain big and expensive, although they're getting more attractive by the day.

Arjun Divecha, GMO's emerging-markets expert, notes that Thailand, Turkey and Russia all trade at single-digit valuations. They're fraught with political risk, he notes, but they're among the many bargains to in the developing world.

### The Bottom Line

After getting slaughtered this year, many emerging-markets shares look like bargains. Avoid the frontier countries and stick with the bigger names and stronger economies initially.

Today, the MSCI Emerging Markets index trades well below 930 (it's ranged from a high of 1338 in 2007 to a low of 767 earlier this month). The 930 figure is important, according to Merrill Lynch, because it's the average level at which the vast majority of money flows from retail investors entered emerging-markets funds between 2002 and 2008. Frightened investors often bail out at or near break-even. If markets rally, investors might simply bail out at those levels, acknowledges Claudio Brocado, an emerging-markets specialist at Batterymarch Financial Management. Still, he avers, "current levels present terrific buying opportunities."

We'd have to agree. Surely there will be turbulence, and further downside is likely if developed markets extend their slides. The rise and fall of oil prices will have an enormous impact on political stability -- as well as infrastructure-spending and social services. But there will be many rewards over the long term. After all, after years of waiting, South Korea was finally upgraded to developed-markets status by London-based FTSE Group, joining the indexing ranks of the U.S., Europe and Japan. MSCI says it may do the same in June. That will vastly expand the pool of buyers who'll consider South Korea for investment, and gives the intrepid investor less cause for worry and more reason to buy.

## Regional Rewards

With decent growth prospects, emerging markets trade at big discounts to the developed world and close to "distressed" levels, says Merrill Lynch.

	— Price Return —		Price to 12-Mo. Forward Earnings**	Long-Term Forward EPS Growth Rate**	Comment
	YTD*	— Annualized — 3-Year 5-Year			
<b>Korea</b>	-35.0%	3.3% 13.8%	9.0	14.7	FTSE upgraded it to a developed market: is MSCI next?
<b>China</b>	-42.7	19.8 20.8	11.9	25.7	Easing begins; first big market to fall could be first to rise
<b>Brazil</b>	-27.7	22.7 36.2	9.2	15.2	If commodities are oversold and the dollar overbought, the place to be
<b>Taiwan</b>	-27.2	0.2 -0.2	12.5	9.5	10% of the MSCI Emerging Index; a liquid play on China
<b>Russia</b>	-42.5	5.7 15.6	6.0	16.3	Cheap, but yields are rising and Moscow is capricious
<b>India</b>	-45.6	16.2 24.1	14.0	19.7	More slowing ahead, but economy will still grow 7%-7.5% this year
<b>South Africa</b>	-26.4	4.1 15.4	8.9	10.9	Finance minister stays in place, alleviating concerns
<b>Mexico</b>	-18.5	12.3 23.0	11.0	24.4	Forecasts its own GDP at 2.8% this year; earnings momentum slowing sharply
<b>Israel</b>	-12.0	9.2 11.7	11.2	11.9	Already ranked developed by FTSE, but not by MSCI
<b>Malaysia</b>	-32.6	7.3 8.3	11.7	11.2	Talk about repegging ringgit to greenback could slow growth, now at 5.7%
<b>Turkey</b>	-41.6	2.1 19.7	7.6	12.1	Strong first-half earnings drew some fans, but currency risks worrisome
<b>Emerging Markets</b>	-33.3	9.1 16.8	9.8	16.8	
<b>EAFE</b>	-25.2	2.01 8.4	10.7	8.6	
<b>S&amp;P 500</b>	-19.2	-2.4 17.5	13.6	NA	

\*As of 9/24. \*\*As of 8/29.

Sources: MSCI Barra; Thomson Reuters; Bloomberg

E-mail comments to [mail@barrons.com](mailto:mail@barrons.com)

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