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Emerging market strength looks set to disappoint the cynics

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If 2008 set many unwanted records in the negative ledger of emerging markets' history, then 2009 has provided a welcome return to the positive side. The 17% surge in May was the largest in the 21-year history of the asset type, and it capped a sustained rally from the 9th March low point, as the MSCI Emerging Markets Index rose by 92% to the end of September. In the initial stages of this spring ascent, the suggestion was that a 'bear market rally' was occurring. The continued pace and stamina of the markets have now dispelled that view. This leads to the inevitable question: how far can emerging markets go?

Closing the gap

If near-term stock market returns were easily linked to the underlying economies, then emerging markets would be clear winners. The economic growth of the asset type is forecast to outpace developed rates of growth by up to three times. This is led by the continued strength of Asia, and especially, but not exclusively, China and India. Latin America has fared reasonably; Brazil barely dipped into negative territory, and Peru displayed resilience akin to an Asian economy. Eastern Europe has been, and will remain the laggard. However, beyond the drag of Western Europe, there are signs of reasonable health in Turkey, Egypt and Russia, the latter provided that the oil price holds above US$50.

For performance to follow, growth needs upside room in valuations. For many years emerging markets offered superior rates of forecast growth at substantial discounts. The five year bull market between 2003 and 2007, which saw over 30% annual price appreciation, has removed the gap, such that emerging equities now trade on similar valuation metrics to those of their developed counterparts. Equally the growth profile in earnings is forecast to be similar. It could be argued that this near-term parity of corporate profits growth is flattering for developed markets, since it includes the financial sector's reversal from enormous losses to profitability. However, once this short-term phenomenon is exhausted, the higher levels of nominal GDP growth should re-establish the growth superiority that emerging markets, by their very level of development, should offer.

A key driver of superior performance could be provided by higher rates of corporate returns, given the factors above. However, the return on equity being achieved in all three emerging regions: Asia, Latin America and EMEA, is superior. The cynic would have some justification in arguing that these higher returns are achieved due to the oligopolies that persist in their home markets. However, oligopolies may be nefarious for the consumer, but remain beneficial for the investor. Moreover, they only constitute a small part of the superior

1 Source: Lipper as at 30 Sept 09

returns seen, which are more generally a reflection of well managed companies, and a survivor bias. The developed world has just suffered its worst crisis in living memory. Conversely, the emerging universe succumbed to several crises from Mexico in 1994, Asia in 1997, Brazil and Russia in 1998, Turkey in 2000 and Argentina in 2001. These countries have been tested by extremes, remedied their deficiencies, and emerged even stronger. The corporates have undergone a similar purge and re-invigoration, and the returns reflect this.

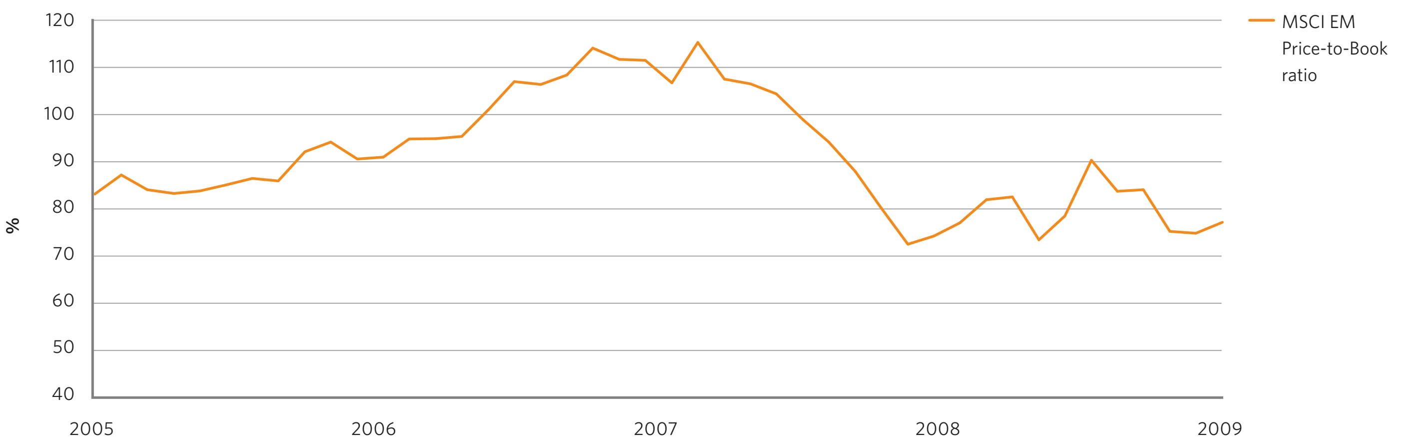
Crystal ball

It is perhaps optimistic to suggest that the record breaking gyrations of 2008 and 2009 will not be repeated, but the next 12 months looks set to offer steady accretion in emerging market economies. They are increasingly trading among themselves, but the importance of trade and exports to North America and Europe should not be dismissed. Therefore, a healthy prognosis for the asset type needs a sustained recovery in the West; the key being how effectively the various stimulus packages are in providing sustainable expansion.

Cyclical commodities represent one third of emerging markets, and their near-term performance is always a key determinant of certain markets. Oil companies are large components of Russia, Brazil, Thailand, Hungary and Colombia, and they typically follow movements in crude oil prices. Information technology, which represents half of the Taiwanese and Korean markets, should resume its unit volume growth, specifically in phone handsets and computers, driven by lowered prices for smart phones and the corporate replacement cycle respectively. Currency movements will affect profitability, but the trend of Korea building branded consumer electronics giants, and Taiwan perfecting its role as a first-choice destination for outsourcing should continue. The warming of relations between Taiwan and China has varied in temperature in 2009, but should continue the trend of rapprochement. Meanwhile, the political climate is relatively becalmed, with a modest electoral timetable.

In 2003 the emerging market asset type reached its nadir, representing barely 3% of world equity markets. It has recently come close to 13% of the same universe; the optimist would suggest that this will not be the zenith. There are the frequently exercised justifications regarding demographics and developmental stages. These are now supported by strong economies and companies, which will be able to invest to produce the step changes that shift potential to reality, without the interruptions caused by imbalances, which have been predominantly exorcised.

EMERGING MARKETS ADJUSTED RETURN ON EQUITY COMPARED TO DEVELOPED WORLD



Source: Blackfriars as at 31 Oct 2009, indices used were MSCI World and MSCI EM www.bnymellonam.com

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