EMERGING MARKETS EQUITY / JULY 2009

The More Dynamic Economies of the Next Decade

After an extraordinary performance in the second quarter of 2009, valuation of emerging markets equities have increased from high-single-digit P/E multiples to low-to-mid teens P/E multiples. Given our bottom-up fundamental approach to determine future potential upside, and the unprecedented amount of recent flows into the asset class, we have changed our positioning in emerging markets: we are now neutral in the short term, constructive in the medium term, and bullish in the long term.

Although emerging countries are now being hurt by the global recession, it is increasingly clear, in our view, that they will be the more dynamic economies over the next decade. We believe that central banks around the world are taking the right steps to restore and ensure financial stability in the developed world, and that this will help emerging markets to continue their secular development, albeit at a lower pace over the medium term. In our opinion, fundamentals are currently significantly better in emerging markets than in developed markets, and they are likely to continue to be good for the longer term. Despite this, and the fact that emerging markets have recorded 28 consecutive quarters of higher profitability and have a better earnings-per-share growth profile, on a price-to-earnings basis they are still trading at a discount relative to the industrialized world.[1] Given this picture, we think that relative valuations of emerging markets equities, currently at mid-range levels over the last twenty years, are not expensive. We anticipate large-scale demand for basic manufactured goods and commodities, now and even more in the future, and relatively strong economic activity with no need for currency pegs.

We believe there is a noticeable difference in growth of emerging markets versus growth of the developed world. This is partly due to domestic demand growth, which has recently been much stronger in emerging markets relative to their history for some time. We believe that this can be an advantage, especially during the current global downturn. In the quarters to come, we feel that the gap between the emerging and developed world will become more and more noticeable to investors, as we do not expect significant economic growth in the developed world, but do expect emerging markets to increasingly rely on domestic demand to be an important driver of growth (though slightly muted) in the emerging economies.

Over the past decade, there has been high credit growth in parts of Western Europe, Ireland, Spain, the Netherlands, and especially Iceland. Emerging markets, on the other hand, have experienced relatively low credit growth, though there are exceptions in the Baltics (Latvia, Estonia, Lithuania) and in Bulgaria, the Ukraine, and Kazakhstan, as these countries were hurt by the devaluation of their currencies, which increased the value of their hard-currency liabilities. However, most emerging markets, and in particular the four major economies (Brazil, Russia, India, and China), are currently in a good standing, thanks to a combination of very modest or even negative credit growth, low debt/GDP ratios, high domestic savings, high foreign exchange reserves, and better current accounts, all of which help to cover short-term external debt payments. This is, obviously, a dramatic change versus the late 1990s, when many emerging countries did not have this type of savings to defend themselves during periods of economic distress; it is also one of the reasons why we believe developing markets will fare well over the long term.

During 2008, a huge unwinding of the carry trade occurred, which caused many emerging market currencies to decrease significantly. We feel that, following the recent drop, these currencies are relatively attractive at this stage; we anticipate fairly moderate appreciation over the coming years for many emerging market currencies, even if at a controlled pace to maintain competitiveness.

In conclusion, as we have consistently reminded investors for quite some time, in our view one size does not fit all within the emerging markets asset class. We believe that, in the future, emerging markets will be viewed as a style-sensitive, complex group of asset classes. We challenge investors to consider the versatility of emerging market approaches; however, we caution that emerging markets are still quite volatile, and remind that they might not be an option for all investors.

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NOTES:

1 As of 31 May 2009. Source: Lazard Asset Management, MSCI

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