

Schroders

2009: A year in Emerging Markets

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- Global emerging markets do not have the same debt problems as the developed world, and will not have to suffer the same process of deleveraging
- Economic fundamentals are strong and these economies are less sensitive than they were to the developed world. Domestic demand means that even in a global slump we would continue to see positive growth
- Share valuations are not reflecting the stronger outlook for economic growth. Even on a more pessimistic view of the outlook, these markets are cheap
- There are risks – but these apply to all markets

“Recent underperformance does not mean that emerging market economies and developed economies have re-coupled, it simply means that investors’ perceptions of what is ‘risky’ and what is not have yet to catch up.”

The problems facing the global economy emanate from the developed markets, not the emerging world. Although the news from emerging market economies has deteriorated – like everywhere else – they will withstand the global recession better than developed markets, and much better than they would have done themselves in the past. Yet this is not yet reflected in markets, which appear too cheap.

The ‘credit crunch’ – the virtual freezing up of lending by banks – is primarily a developed market problem, created in the developed world. In the last six years, for example, personal debt in the US grew by as much as it had in the previous forty years. Too much cheap lending has now resulted in a complete and dramatic reversal of this trend, with banks unwilling to lend to other banks, unsure of their financial solvency.

The upshot is that expectations for global economic growth have deteriorated sharply in recent months. In this environment, growth in the emerging world will also slow next year. Just like everywhere else in the world, more difficult times are ahead.

The only place to go for growth

Newspapers are filled with stories every day now about the slowdown in economic activity in countries around the world. India and China – where manufacturing activity has slowed, along with other emerging markets, have been no exception. The difference is, we believe, that overall economic growth will remain in positive territory – unlike the US, UK and Europe, where the process of debt reduction is likely to be protracted and will dampen spending and investment.

Schroders is forecasting economic growth at 3.5% in emerging economies in aggregate next year, versus a fall of 1% in the OECD. In fact, emerging market economies should be at the forefront of global economic recovery when it comes – albeit gradually – in 2010.

Economic decoupling

Emerging economies are less dependent on the developed world for growth than they were a few years ago. Strong demand from within their own growing economies, and trade with other growing emerging market countries (particularly China and India), make these economies much more self-sufficient. Once they would have been the worse hit in a global recession; now they are able to withstand a US-led downturn better than markets like the UK.

Across the region, revenues from exports to other emerging markets have now overtaken exports to the industrial nations, and domestic demand in many countries is growing at a very fast pace. This is particularly the case in China, where demand for Chinese products provided around four times more contribution to its domestic economic growth than total exports did in 2007. That trend is expected to continue. Of course, exports from China to the developed world will inevitably slow, but planned increases in Chinese government spending should help to offset this: the government announced a national stimulus package, totaling \$586 billion, this November, which should see more infrastructure spending on roads and other projects.

Emerging markets are not borrowed up to the hilt

Local banks have little exposure to the toxic assets that have been part of the reason for the meltdown in the global financial system. Furthermore, debt levels in these economies are generally modest. While emerging markets will suffer in the short-term from the global



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The risks

That recession is longer and deeper than expected and the recovery does not start in 2010:

This will be a negative for all markets, and we would expect emerging to hold up better than developed economies in this scenario: Schroders' Chief Economist is predicting modest positive growth in emerging markets even in this 'slump' scenario, and stockmarkets should move to reflect that.

Significant US dollar strength:

historically a negative for emerging markets stockmarket performance. The dollar strengthened as countries borrowed to push down their own currencies and keep exports competitive. However, this has started to reverse and, when there is more clarity on the economic outlook, the dollar should stabilise or even weaken.

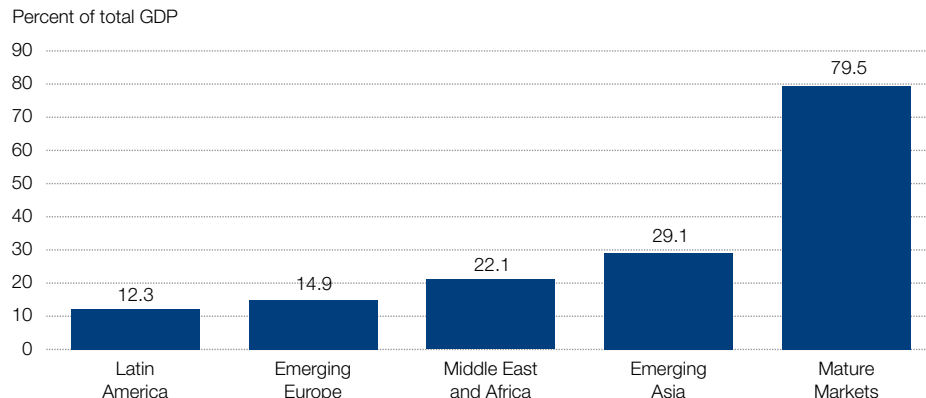
Further weakness in commodity prices:

often seen as a major risk for emerging markets, but the fact is that more countries are, in net terms, consumers rather than producers of commodities like oil. While certain countries – those in the Middle East, and Russia, for example – would of course suffer if there are further significant falls in commodity prices, more of the 25 emerging markets would benefit.

liquidity squeeze, they will not suffer the same issues that developed markets are currently going through in terms of long and painful period of reducing debt.

The chart below shows household debt as a percentage of the total economies in emerging market regions compared to the developed world.

Household debt as a percentage of the total economy



In fact, there is actually potential in emerging markets for household debt to rise further, which will support future growth in consumption. Public sector debt in emerging markets is also low compared to developed markets.

Other economic fundamentals are good compared to developed markets. Foreign reserves are at a record high and foreign debt has declined sharply – resulting in a dramatic turnaround in the net trade balance.

Markets are cheap relative to developed markets

Despite the extent of economic decoupling, these stockmarkets have been at the sharp end of the sell off in global equities this year. As investors have reacted to a more gloomy global environment, they have written off emerging markets as too risky and taken profits on extremely good returns in the previous few years. Record inflows from foreign investors in 2005, 2006 and 2007 became record outflows this year.

This can have some knock-on effect on economies themselves, of course, as large outflows of foreign investment takes its toll on companies.

But this does not reflect the underlying economic picture relative to the developed world. Recent underperformance does not mean that emerging market economies and developed economies have re-coupled, it simply means that investors' perceptions of what is 'risky' and what is not have yet to catch up.

There could continue to be more volatility and disappointments in the short term as more companies issue results; investors are arguably still a little unrealistic in their company profit expectations. Even so, the current price/earnings ratio across emerging markets is 7.5 times next year's corporate earnings. This compares to a longer-term average of around 13 times for the region. The p/e of the US market and the average p/e for global markets are now both over 9 times. Valuations may be flattered by overly optimistic company earnings forecasts, but even if downgrades are factored in and the 'e' part of the p/e equation falls, these markets are still likely to offer much better value.

The best place to be

Of course, uncertainty on a global basis is dominating stockmarkets at the moment – no one is sure how long before we see the shoots of economic recovery, or how many more bank bailouts there will be. This means we are seeing sharp swings in markets on a daily basis everywhere, but also that investors have lost their sense of perspective on emerging markets' prospects for the longer term. But given that economic fundamentals in these markets are stronger and that they will be able to withstand the global economic downturn, yet still offer more attractive valuations, we think they are the best place to be.