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GLOBAL MARKET COMMENT

EMERGING MARKETS EQUITIES: MORE ROOM TO RUN

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Emerging Markets Equities: More Room to Run

Virtually all global equity investors had reason to smile in 2003, but particularly those with money in emerging markets equities, as the MSCI Emerging Markets Free (EMF) Index returned an eye-popping 46.7% for the year, with 14 of the 26 constituent markets posting returns of more than 50%. (All returns are total returns in local currency unless otherwise noted.) This is the second straight year emerging markets equities have far outpaced their developed counterparts, although outperformance in 2002 was more a case of losing less ground than posting stellar returns. We remain positive on the asset class for a number of reasons: most notably, valuations are generally lower than historic averages as well as appearing cheap relative to developed markets' stretched multiples, while recent reforms in several countries appear to bode well for long-term growth.

Still, it is worth noting that valuations are no longer the screaming bargain they appeared in early 2003, when we strongly recommended the asset class.[1] At that time, the EMF Index looked cheap on a number of metrics, including price-to-earnings, price-to-book, price-to-cash earnings, and dividend yield ratios. The persistent rally in emerging markets equities since then, however, has eroded much of this benefit. In other words, much of the low-hanging fruit has already been picked. Among subregions, we consider Latin America and South Africa to be undervalued, while Asia and Europe and Middle East look fairly valued.

As is generally the case with emerging markets, 2003 returns varied widely among countries, and certain markets experienced significant currency fluctuations. Nonetheless, returns remained strong across the board: the EMF Index returned 30.0% in euros, 40.5% in pounds, and 56.3% in US$.

Individual countries, of course, saw more dramatic currency fluctuations, but even here the issue was not whether returns were positive or negative, but rather how much return was sacrificed or gained due to currency movements. For example, while the Venezuelan market soared 192.9% in local terms in 2003, the *bolivar* fell 51.4% against the US$ for the year, leaving unhedged US$-based investors with a 42.4% return. The performance differential was even more striking in euro terms, as its 59.4% appreciation against the *bolivar* resulted in an 18.5% return in euro terms.

The worst-performing emerging market in 2003 was South Africa, which, despite being a resource-rich country, returned only 13.5% during a year when commodities prices soared. However, investors that did not hedge their currency exposure benefited significantly as South Africa's *rand* appreciated against all major currencies. In US$ terms, MSCI South Africa returned an impressive 45.9%, while the index returned 31.2% when measured in pounds, and 21.3% for euro-denominated investors.

MSCI Latin America was the best-performing subregion for the year, returning 60.8% to nose out MSCI Europe and Middle East, which returned 58.0%. Looking forward, there are reasons to believe Latin American equities could continue to do well, as valuations remain reasonable and many of the region's economies look healthier than in the past.

[1] For more details, see our March 2003 Global Market Comment: *Emerging Markets Equities: Irresistibly Cheap.*

Brazil, for example, which as recently as 2001 ran a current account deficit of nearly 5% of GDP, now boasts a current account surplus, and analysts are optimistic the good news will continue. Morgan Stanley, for example—not known for its overly optimistic economic predictions—expects the Brazilian economy will grow 4.4% in real terms this year. Argentina, meanwhile, continues to recover from its recent woes: while the *peso* initially plummeted relative to the US$ after the break with convertibility in January 2002, it has since stabilized, and actually appreciated 14.7% against the greenback in 2003. As a result, inflation has dropped from 41% in December 2002 to 4% today, and here also analysts expect conditions to continue improving. Barclays Capital, for example, expects Venezuela to boost its foreign reserves by $8 billion in 2004, pushing them close to their record level of $30 billion recorded in the 1970s.

MSCI Asia, meanwhile, which represents 54.0% of the EMF Index, returned 48.8% for 2003, as solid gains in index heavyweights Korea and Taiwan were bolstered by outsized returns in smaller markets such as China and Thailand. (As noted in previous publications, ongoing discussions could lead to the graduation of Korea and Taiwan to developed markets status as early as 2005, a development that would radically alter the makeup of emerging markets indices by shifting their focus from Asia to Latin America. We will cover this issue more closely in a forthcoming publication.)

Within the index, however, there are significant differences between markets. Thailand, for example, remains one of the more attractive markets despite its 124.8% return in 2003, as valuations are still low and the economy has been on a tear—growth likely topped 6% last year. Analysts' expectations are also reasonable when measured against forecasts for other Asian countries: Thai companies are projected to grow earnings nearly 21% in 2004, far below the 50% and 39% expectations for Korea and Taiwan, respectively. Lower earnings growth expectations create more room for positive surprises to boost Thai shares. Warnings that Thai consumers are on a credit binge similar to their Korean counterparts, meanwhile, seem unfounded. For the five years ended in third quarter 2003, consumer loans in Thailand, including housing loans, have risen a mere 11%, while Korean consumer loans have soared 136%. According to the World Bank, Thai household debt to GDP is expected to reach 20% in 2004; the comparable figure for Korea hit 70% in 2002.

While foreign investors have lately been net sellers of Thailand shares and net buyers of Korea, local investors, who often presage market moves through their actions, appear to be doing just the opposite. Thai institutions have been net buyers of Thai shares for each of the past seven months, while Korean institutions have been net sellers of Korean equities for each of the last eight months. In the case of Korea, much of the foreign interest likely has to do with capital inflows to emerging markets equities in general, as Korea represents nearly 20% of the index, compared to Thailand's relatively small weighting of 3.2%.

MSCI China returned a whopping 87.6% in 2003, as China's rapid economic growth and increasing role in the global economy attracted significant investor attention. While China has significant investment potential, it is too early for Chinese equity investments other than a limited number of toe-in-the-water private equity investments for those with diversified programs.[2] There are, however, some issues investors should keep their eye on, as developments in these areas could have global implications.

[2] For more details, see our April 2003 Global Market Comment: *Investing in China: Not Yet* and our 2003 papers: *Investing in Listed Chinese Equities* and *Chinese Venture Capital Investing.*

The Chinese banking system, to begin with, remains quite cloistered, and it is fair to say no one really knows the extent of the country's bad loan problem. (Estimates range from the government's figure of 21% of all outstanding loans to private numbers that run as high as 50%.) In addition, concerns about Chinese overheating have begun to surface, with many observers skeptical the country can continue to grow its money supply at 20% a year without causing a speculative bubble. Finally, China and its pegged currency have become the global whipping boys for politicians eager to find a scapegoat for job losses and stagnant economies. While there is little truth to most of the claims being made—e.g., that U.S. manufacturing jobs are going overseas because the Chinese *yuan* is too low, or that China's strength is sapping European economies' vitality—they could nevertheless lead to a global backlash against China through trade restrictions, tariffs, and other forms of protectionism that would ultimately weaken the global economy.

Overall, emerging markets enter 2004 in remarkably good shape. Strong gains in 2003 did not markedly diminish the relative attractiveness of the asset class, as emerging markets equities remain inexpensive compared to their developed peers. Further, of the six largest emerging markets, five are now rated investment grade, with Brazil the lone holdout. Even in the case of Brazil, however, where political risk is always a wild card, new president (and former populist and union leader) Luiz Inacio Lula da Silva has surprised and delighted investors by pushing through a number of business-friendly initiatives. While investors in emerging markets should always be cognizant of the risk of severe dislocations, therefore, relatively low valuations and increasingly healthy economies should provide investors with some measure of downside protection. However, if the global recovery suffers a relapse, we would expect emerging markets equities to underperform. While the risk/reward ratio of emerging equities is favorable, only investors who can tolerate their inherent volatility should consider making commitments.

Table A

MSCI EMERGING MARKETS FREE TOTAL RETURNS

In Local Currency

	One-Month 12/1/03-12/31/03	Three-Month 10/1/03-12/31/03	Trailing One-Year 1/1/03-12/31/03	Cumulative Trailing Three-Year 1/1/01-12/31/03
Emerging Markets Free	6.9	17.6	46.7	47.1
EMF Asia	6.7	18.1	48.8	48.4
China	15.6	34.5	87.6	21.4
India	15.8	31.0	69.7	52.2
Indonesia	11.6	15.0	67.7	102.8
Korea	1.9	18.4	36.6	106.8
Malaysia	0.7	9.4	26.6	31.5
Pakistan	7.5	8.3	40.0	176.6
Philippines	11.4	12.0	48.5	-9.1
Taiwan	1.8	3.6	39.2	22.1
Thailand	30.0	41.1	124.8	200.0
EM Europe & Middle East	6.4	10.2	58.0	37.6
Czech Republic	7.7	7.4	41.9	60.2
Egypt	6.6	22.2	155.4	81.3
Hungary	2.7	4.8	22.1	15.4
Israel	-1.7	8.5	45.8	-18.9
Jordan	4.7	11.4	57.6	121.5
Morocco	1.7	3.1	29.0	-2.1
Poland	8.0	6.5	32.2	-9.8
Russia	6.9	5.8	75.9	217.3
Turkey	26.4	42.0	91.2	105.0
EMF Latin America	8.7	23.0	60.8	73.7
Argentina	17.6	28.4	75.5	139.0
Brazil	15.3	36.3	75.2	83.1
Chile	2.7	3.7	51.7	48.4
Colombia	9.2	23.4	61.9	279.2
Mexico	1.8	12.0	42.6	59.6
Peru	6.2	40.4	91.5	198.7
Venezuela	11.7	27.6	192.9	356.3
MSCI South Africa	6.1	15.4	13.5	36.3

Source: Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Table B

MSCI EMERGING MARKETS FREE TOTAL RETURNS

In Euros

	One-Month 12/1/03-12/31/03	Three-Month 10/1/03-12/31/03	Trailing One-Year 1/1/03-12/31/03	Cumulative Trailing Three-Year 1/1/01-12/31/03
Emerging Markets Free	1.9	8.8	30.0	6.7
EMF Asia	1.9	7.5	25.6	13.7
China	9.9	24.2	56.0	-9.6
India	10.4	21.3	48.4	15.9
Indonesia	7.1	5.8	48.2	73.4
Korea	-2.3	5.6	13.1	63.4
Malaysia	-4.3	1.0	5.3	-2.1
Pakistan	1.9	0.9	18.4	106.6
Philippines	6.2	2.2	18.8	-39.1
Taiwan	-2.7	-4.9	18.6	-11.4
Thailand	24.5	31.3	103.5	144.4
EM Europe & Middle East	2.9	3.3	38.4	-4.2
Czech Republic	6.5	5.9	38.3	74.7
Egypt	1.3	12.4	59.6	-14.8
Hungary	3.2	1.9	10.1	16.9
Israel	-5.5	1.3	31.1	-44.4
Jordan	-0.5	2.9	31.2	65.1
Morocco	0.6	1.3	24.0	-12.3
Poland	7.2	3.4	12.7	-25.9
Russia	1.5	-2.3	46.4	136.2
Turkey	25.0	29.9	87.9	-27.2
EMF Latin America	5.5	14.4	44.5	-0.2
Argentina	13.8	17.7	67.5	-39.4
Brazil	11.9	27.7	78.9	-7.9
Chile	2.4	6.8	53.4	7.0
Colombia	5.9	18.2	38.9	127.0
Mexico	-1.7	1.5	10.5	1.6
Peru	1.4	30.3	61.7	126.4
Venezuela	-5.1	-34.0	18.5	-16.7
MSCI South Africa	-3.5	11.2	21.3	15.1

Source: Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Table C

MSCI EMERGING MARKETS FREE TOTAL RETURNS

In Pounds Sterling

	One-Month 12/1/03-12/31/03	Three-Month 10/1/03-12/31/03	Trailing One-Year 1/1/03-12/31/03	Cumulative Trailing Three-Year 1/1/01-12/31/03
Emerging Markets Free	3.0	9.3	40.5	19.7
EMF Asia	3.1	8.1	35.8	27.4
China	11.1	24.8	68.7	1.3
India	11.6	22.0	60.4	29.9
Indonesia	8.2	6.4	60.3	94.4
Korea	-1.2	6.1	22.3	83.2
Malaysia	-3.3	1.6	13.9	9.7
Pakistan	3.0	1.4	28.0	131.7
Philippines	7.4	2.8	28.4	-31.7
Taiwan	-1.6	-4.4	28.2	-0.7
Thailand	25.9	32.0	119.9	174.0
EM Europe & Middle East	4.0	3.8	49.6	7.4
Czech Republic	7.6	6.4	49.5	95.9
Egypt	2.4	13.0	72.5	-4.5
Hungary	4.4	2.4	19.0	31.1
Israel	-4.5	1.8	41.7	-37.7
Jordan	0.6	3.4	41.8	85.1
Morocco	1.7	1.9	34.0	-1.7
Poland	8.4	3.9	21.8	-16.9
Russia	2.7	-1.8	58.2	164.8
Turkey	26.4	30.6	103.1	-18.4
EMF Latin America	6.6	15.0	56.2	11.9
Argentina	15.1	18.4	81.1	-32.1
Brazil	13.1	28.4	93.4	3.3
Chile	3.5	7.3	65.8	19.9
Colombia	7.0	18.8	50.1	154.5
Mexico	-0.7	2.1	19.4	13.9
Peru	2.5	31.0	74.8	153.8
Venezuela	-4.1	-33.6	28.1	-6.6
MSCI South Africa	-2.4	11.7	31.2	29.0

Source: Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Table D

MSCI EMERGING MARKETS FREE TOTAL RETURNS

In U.S. Dollars

	One-Month 12/1/03-12/31/03	Three-Month 10/1/03-12/31/03	Trailing One-Year 1/1/03-12/31/03	Cumulative Trailing Three-Year 1/1/01-12/31/03
Emerging Markets Free	7.2	17.8	56.3	43.4
EMF Asia	7.3	16.5	51.0	52.7
China	15.6	34.5	87.6	21.4
India	16.1	31.4	78.4	55.7
Indonesia	12.7	14.6	78.2	132.9
Korea	2.8	14.3	35.9	119.6
Malaysia	0.7	9.4	26.6	31.5
Pakistan	7.2	9.3	42.4	177.6
Philippines	11.8	10.7	42.8	-18.2
Taiwan	2.4	3.0	42.5	19.0
Thailand	31.0	42.2	144.6	228.4
EM Europe & Middle East	8.3	11.8	66.4	28.7
Czech Republic	12.0	14.7	66.2	134.8
Egypt	6.6	21.7	91.8	14.4
Hungary	8.6	10.4	32.3	57.1
Israel	-0.6	9.7	57.5	-25.4
Jordan	4.7	11.4	57.7	121.9
Morocco	5.9	9.7	49.0	17.8
Poland	12.8	12.0	35.5	-0.5
Russia	6.9	5.8	75.9	217.3
Turkey	31.5	40.7	125.9	-2.2
EMF Latin America	11.0	23.9	73.7	34.1
Argentina	19.8	27.5	101.3	-18.6
Brazil	17.7	38.3	115.0	23.8
Chile	7.8	15.7	84.4	43.7
Colombia	11.4	28.1	66.9	205.0
Mexico	3.4	10.0	32.8	36.5
Peru	6.7	41.1	94.3	204.1
Venezuela	-0.1	-28.5	42.4	12.0
MSCI South Africa	1.6	20.4	45.9	54.6

Source: Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Table E

MSCI EMERGING MARKETS FREE VALUATIONS

As of December 31, 2003

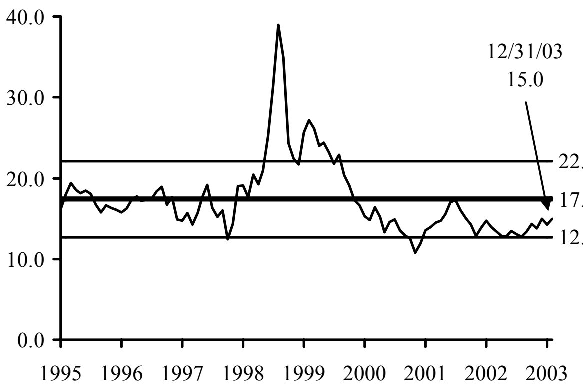
	Price-to-Book	Price-to-Cash Earnings	Price-Earnings	Dividend Yield (%)
Emerging Markets Free	1.9	9.1	15.0	2.3
EMF Asia	2.0	10.5	16.7	2.0
China	2.2	9.4	17.1	2.2
India	3.8	14.5	19.0	1.5
Indonesia	2.3	7.6	10.4	3.8
Korea	1.5	9.9	13.9	1.8
Malaysia	1.8	10.3	16.3	2.4
Pakistan	2.3	6.4	8.7	8.6
Philippines	1.4	8.7	20.2	1.4
Taiwan	2.1	12.1	25.7	1.9
Thailand	2.9	9.7	15.2	1.7
EM Europe & Middle East	1.7	8.5	14.6	1.8
Czech Republic	1.1	4.6	12.5	6.9
Egypt	2.2	6.9	10.9	4.7
Hungary	2.0	5.8	13.1	0.9
Israel	2.5	17.9	34.1	1.1
Jordan	2.0	10.8	21.4	2.4
Morocco	1.5	8.3	8.3	8.3
Poland	1.7	4.5	19.5	1.3
Russia	1.3	8.1	11.1	2.4
Turkey	2.0	9.9	11.0	0.9
EMF Latin America	1.9	7.0	13.2	2.6
Argentina	1.8	4.8	13.7	1.1
Brazil	1.8	6.0	10.3	3.5
Chile	1.6	10.4	30.8	1.8
Colombia	1.3	8.6	8.9	3.9
Mexico	2.2	7.9	15.7	1.8
Peru	2.8	21.3	26.4	1.7
Venezuela	1.4	5.6	24.4	3.7
MSCI South Africa	2.0	8.7	12.7	3.2

Table E (continued)

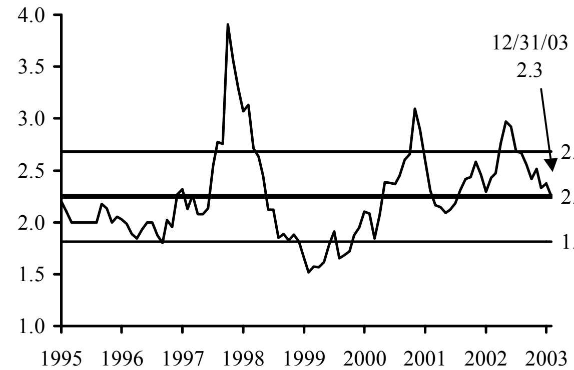
MSCI Emerging Markets Free

November 30, 1995 - December 31, 2003

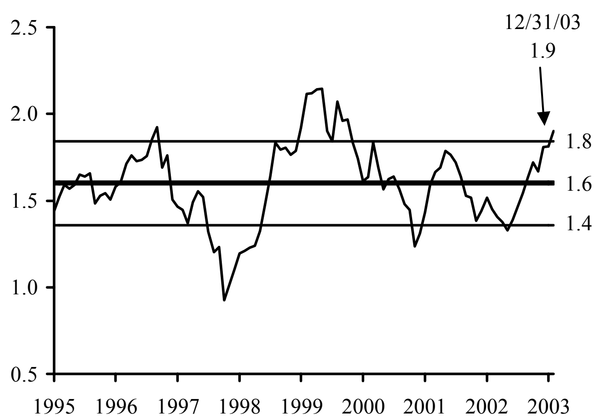
Price-Earnings



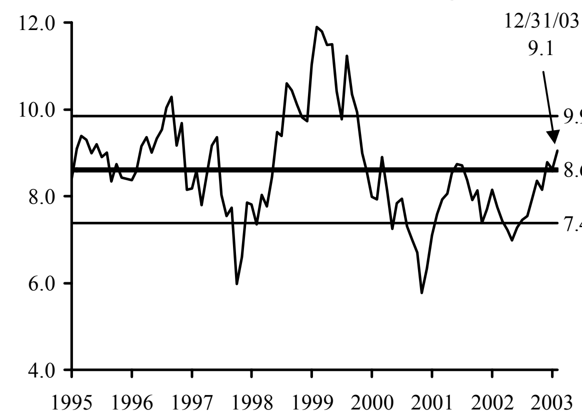
Dividend Yield (%)



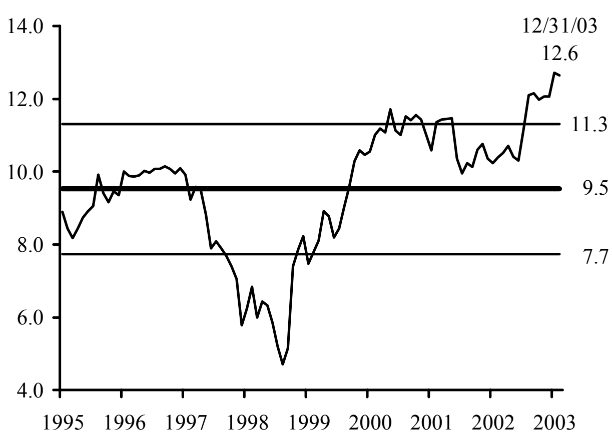
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)



Source: Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: ROE is calculated by dividing the earnings per share by the book value per share. Book value per share is calculated by dividing the index price by its price/book ratio. Earnings per share is calculated by dividing the price index by its price/earnings ratio.
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