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2012 OUTLOOK
EMERGING MARKETS COMMENTARY

Emerging Markets Equities: Balancing Fire and Ice

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2012 Outlook Emerging Markets Commentary

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While emerging markets equities remain attractive in the long term, the short-term risks posed by the European debt crisis and the potential for a global recession to pressure earnings growth merit caution. We recommend remaining at policy target allocations and considering building overweights on further weakness.

Emerging markets equities ran out of momentum at the beginning of 2011 as investors responded to tightening monetary policies designed to combat rising inflation. Valuations are somewhat below historical averages and trade at a slight discount to developed markets equities. While these markets remain attractive in the long term, there are important short-term risks that must be considered.

Today, we are most concerned with the following three broad risks: the challenge of balancing between supporting growth and controlling inflationary pressures; political risk at home and abroad; and the risk of global recession and its potential to pressure earnings growth. In this commentary, we review these risks for emerging markets generally, as well as some of the major country constituents (the BRICs).[1]

We conclude that absent severe negative global conditions, emerging markets equities are reasonably priced and have upside potential, as at least a mild recession is already priced in. As such, we recommend that investors remain at policy target allocations and, despite our positive long-term outlook, wait to accumulate further exposure to these markets on weakness.

2011 Performance

The disappointing performance of emerging markets this year needs to be placed in context. Like most equity markets, after a strong start—briefly interrupted by the Japanese earthquake and Arab Spring in the first quarter—emerging markets peaked during the second quarter (Exhibit 1). Compared to developed markets, emerging markets posted a creditable performance, coming within about 10% of their previous all-time peak. Emerging markets equities had a better recovery than developed markets equities, moving from undervalued in early 2009 to fully valued in 2010 (Exhibit 2). Relative momentum of emerging markets had been very strong right out of the gate at the bottom and peaked early at close to 60% 12-month outperformance in November 2009 (Exhibit 3). In other words, once investors became convinced of the recovery, they embraced risk and the growth story and rushed for the higher beta available from emerging markets, under cover of the better long-term fundamentals. Since early May of this year, emerging markets have once again underperformed developed markets, most noticeably since the start of the downward correction in third quarter 2011 (Exhibit 4).

The outperformance of emerging markets had already begun to rollover well before 2011 (Exhibit 3), but inflows only dried up and started to reverse from late 2010 onward as fundamental investors sensed that conditions were no longer

[1] BRICs include Brazil, Russia, India, and China, which are the largest emerging markets by GDP. China and Brazil have the largest market capitalizations among emerging markets included in the MSCI Emerging Markets Index.

as supportive and shorter-term momentum players became disappointed. In spite of superior growth, emerging markets stood on relatively rich valuations and were being undermined by rising inflation and related tightening of monetary policy in several important countries. Although flows briefly turned positive once more in early November, this was after three months of outflows resulting in a net outflow so far this year of roughly $37 billion to end November, nearly as great as for the whole of 2008 (Exhibit 5).

Of course, the re-igniting of the European debt crisis over the summer added an unwelcome twist to fears that the emerging markets high-growth story might come off the boil. The newly installed head of the European Central Bank (ECB), Mario Draghi, predicted an imminent recession in the Eurozone, and similar fears echoed from the top of the Chinese leadership. Not only is Europe the largest export destination for some emerging countries, but the contraction in cross-border financing from European banks under pressure to improve capital ratios and burdened with European government debt of questionable value means that the spillover from this crisis could materially impact other regions.

Emerging markets as a whole have lost 12.5% for the year through November 30 (Exhibit 6), worse than the MSCI World Index return of -6.0%. Within the emerging markets group, there has been considerable divergence in performance among the heavyweight countries. India (-22.0%) and China (-20.2%) have performed the worst, while less-popular Indonesia is up 4.2%. Taiwan, which some managers consider to be part of greater China, is off 19.3%, hit by softening demand for its chip-related export businesses. Nevertheless, it is important to place this bear phase in context. As shown in Exhibit 7, the peak-to-trough decline of 29% in US$ terms (22% in local terms) from May 2 to September 26, while damaging to investors' portfolios in the short term, is nothing out of the ordinary for these markets. In the past, such declines have typically been followed by meaningful rallies of at least 20%.

Sectors performed as one would expect. Fears about the health of the Chinese banks and real estate developers contributed to a 19.4% fall in financials year-to-date through November. Materials were also particularly weak (-18.3%) on the back of declining demand from China, which impacted several commodity producers in supplying countries such as Brazil. Defensive sectors such as consumer staples (8.0%) and telecommunications services (3.8%) were the only ones in positive territory (Exhibit 8). Unfortunately, their weights in the index aggregate to 16.3%, while financials remain the largest sector with a 23.3% weight. From this perspective, some of the doubts concerning the soundness of banks and overextended lending are unfortunately in phase with the worries in the West, undermining the diversification benefits of emerging markets.

The year is closing with a reversal of policy in many countries as cuts in interest rates and bank reserve requirements are occurring even in the face of moderately high inflation above official targets. The fall in China's inflation rate to only 4.2% in November sets the scene for more easing in 2012. The market gyrations of 2011 mean that valuations have shifted meaningfully over the year. This switch back to the growth priority seems to have stabilized markets, at least in the short term, and has helped move valuations back toward fair value from clearly undervalued at the end of the third quarter. This is still a big change from earlier in 2010, when emerging markets traded in overvalued territory.

Valuations

As a whole, we consider emerging markets to be on the lower bound of fair value, but not quite undervalued. These markets have rapidly moved from overvalued to undervalued between early 2010 and today (Exhibit 9). If we zoom in on regions, emerging Europe, the Middle East, and Africa (EMEA) has become the cheapest region, with regional heavyweight Russia at 0.7 standard deviation below the mean. Latin America appears relatively less attractive, and its propensity to slide into populist policies—which can quite easily bring back the specter of excessive inflation—leaves us with some reservations. While Asian equities appear quite cheap, much of this undervaluation is attributable to Chinese financial and property stocks, which we view as potential value traps. Therefore, we view Asian equities at the very low end of the fair value range, while Latin American equities are fairly valued and EMEA equities are undervalued. A similar picture can be seen using forward price-earnings (P/E) ratios (Exhibit 10) and our composite normalized P/E measures.

This cheapening over the past 18 months or so is a result of a market de-rating as earnings estimates remain on an upward path, and on the whole above their previous peak, even as they have recently trended down (Exhibit 11). Of course, this could be another case of the analyst community's tendency to extrapolate current trends for future earnings. Given that real earnings per share (EPS) are back to cyclical highs, far above trend-line EPS and composite EPS measures (Exhibit 12), some caution is warranted, even after the recent cheapening.

Looking at other valuation metrics, such as price-to-book (P/B) (Exhibit 13), emerging markets are roughly in line with global markets, but not particularly cheap compared to their own history. The clear uptrend against developed markets stretching back to 1998 has paused over the last few years, although emerging markets do enjoy a higher return on equity (ROE) than developed markets, as has generally been the case since the beginning of the last decade.

The point is that although emerging markets are valued comparably to developed markets and arguably slightly undervalued relative to their own history, this may be a case of the markets discounting a deterioration in real earnings from current high levels for a variety of reasons. These reasons broadly fall into the following categories: trade-off between growth and inflation, political risk at home and abroad, and risk of a global recession.

Risks

Growth and Inflation

We have previously alluded to the "growth paradox" that forced central banks in emerging markets to tighten policy as growth picked up smartly from 2008 and countries such as China continued to accumulate reserves from currency intervention. As inflation rose once more above targets in emerging markets (Exhibit 14), driven by essentials such as food, energy, and housing, authorities were sensitive to the dangers of popular unrest, à la Arab Spring. This tightening of monetary policy has successfully cooled speculative activity, but has also exerted pressure on export industries either through exchange rate appreciation or wage pressures, reversing investor flows back to less volatile assets.

To place this in perspective, any slow down of activity in emerging markets will probably be to levels of growth that developed markets can only dream about (with the exception of Brazil, where growth seems to be cooling more rapidly).

That said, the authorities are performing a delicate balancing act, keeping the economies sufficiently on the boil to ward off discontent, while grappling with the twin consequences of destabilizing inflationary pressures and the likelihood of "mal-investment" from overinvestment in projects that can only be economic on the assumption of continued rapid growth. As time goes by, there is a growing fear that we may be approaching the limits of this strategy and that populist responses to pressure—such as recent surprise cuts in interest rates in Brazil—may derail sound economic governance. In other words, we may be buying social peace for now, at the expense of less manageable macroeconomic imbalances later.

Political Risk

The sudden and sometimes violent overthrow of hitherto stable regimes in North Africa this year was a wake-up call that there are limits to the disenfranchisement and repression of people, even by the most entrenched leaders. Although other emerging markets are not plagued by the widespread poverty of the revolting Arab countries, it would be surprising if the rising middle classes and the young digital generation do not become ever more vocal in their demands for a greater say in how their nations are governed and how the spoils are shared, especially in China and Russia. There is no guarantee an eventual transition process will be smooth.

These concerns, however, are probably not relevant in the near term. Despite the bumpy ride of Vladimir Putin's United Russia Party in the recent parliamentary elections, the likelihood is that Putin will be elected as the next Russian president in March 2012, although he may have to build bridges with the opposition. In China, we expect the ruling party to manage the generational handover of power relatively smoothly, assuming the feared hard landing does not materialize next year.

Another long-term risk to the structural growth story is the resurgence of protectionism. We should be sensitive to the fact that emerging markets have been the prime beneficiaries of corporate outsourcing and globalization. Should this model come under pressure as developed markets continue to fail to fully recover—with unemployment remaining high and little median real income growth—one can imagine a material increase in protectionist measures. China's attempts to move up the "value chain" could run into more forceful resistance from western countries that are now grappling with structurally weak labor markets.

Threat of Global Recession

We still adhere to the structural growth story for emerging markets. Their better public balance sheets provide them with the option of boosting public spending to mitigate the potential damage of any eventual credit bust.

In contrast to emerging markets, most developed economies have not been able to undergo a normal cyclical recovery driven by credit expansion. On the contrary, households' excessive debt loads and governments' unsustainable budget deficits in key developed countries are driving a necessary process of deleveraging that has prevented the normal cyclical bounceback that markets are accustomed to after a recession. Investors need to adjust to a lengthier recovery timeline as the excesses and imbalances (including uncompetitive labor costs) accumulated over decades are washed out of the system.

At the same time, with developed country fiscal policy unable to contribute to demand given such high public sector debt levels, the only remaining levers available to cushion the effects of the inevitable deleveraging process are held by the central banks. With divergent views about the efficacy and wisdom of engaging in further quantitative easing, and the ECB unwilling to act as the lender of last resort to the peripheral governments of the Eurozone, the likelihood of the second-largest regional economy in the world tipping back into recession seems a foregone conclusion. As Europe is the largest export market for emerging countries such as China, the knock-on effects are inevitable. The key question is whether the prolonged, very low average growth rates and deflationary pressures from deleveraging developed markets will translate into a regular cyclical downturn in emerging markets relative performance and valuations.

Not much has changed since 2008, besides emerging markets' increasing proportion of the global economy, making their policy response to developed markets conditions more important than before. Exports remain key economic growth drivers (in Korea's case, making up 50% of GDP). Although resource-rich Brazil and Russia sell a lot of their output to China, insofar as China is itself a driver of global growth, it is still fair to say that emerging markets tend to be relatively high beta plays on their own economic growth, which is inextricably linked to global growth.

Bulls have long argued that emerging markets are increasingly capable of "de-coupling" from developed markets economies that are mired in the aftermath of the financial crisis. This proved false in 2008, although countries such as China quickly bounced back after a relatively shallow decline thanks to a massive fiscal pump-priming exercise. For all the talk of increased inter–emerging markets trade superseding traditional exports to hobbled developed markets, this is not yet reflected in sufficient volume to support this thesis. The other hope was the substitution of domestic demand for external surpluses in emerging markets as leaders realized they were reaching the sell-by date of their long-standing mercantilist business model.

Although it is true that these helpful trends have been in place, their progress is slow and 2011 once again showed that talk of de-coupling is premature. Returns for emerging markets remain highly correlated with global (OECD) leading economic indicators (Exhibit 15), and exports remain a substantial driver of GDP for the largest emerging markets countries (BRICs) (even if this factor has decreased modestly in recent years) (Exhibit 16). As a result, they are still sensitive to developed markets growth and reluctant to tolerate much appreciation of their currencies as developed markets undergo various forms of quantitative easing. Although BRIC exports to emerging and developing nations have grown from 25% in 1999 to around 35% of total exports (Exhibit 16), this is still dwarfed by the 65% of exports destined for the developed markets. Within the BRICs, the lion's share of the increase in inter-BRIC exports has been to China, with its voracious appetite for raw materials and energy to feed its investment and construction boom. When it comes to manufactured goods, emerging markets countries such as Mexico are more likely to be in competition with China for business in the United States than benefitting from greater demand from other emerging markets.

The evidence remains that emerging markets are still highly correlated with developed markets. Emerging markets do have the firepower to cushion the slowdown coming from abroad, but are becoming constrained by the inflationary pressures noted above in how far they can compensate. Emerging markets are gradually weaning themselves off the need to export to the heavily indebted western economies (in China's case, explicitly espousing a policy of rebalancing growth toward domestic consumption). However, this remains a work in progress, and will play out over the long term rather than the next 12 months. It is probable that another widespread recession in western economies would bring earnings down below what is currently discounted.

Of course, it is dangerous to apply a broad brush analysis to all emerging markets, as each has its own idiosyncrasies. Below, we briefly look into some of the leading countries to give a flavor of their differences as well as common ground.

The BRICs

China

Inflation, driven by food and energy prices (and of course real estate prices), has been a problem for many emerging countries. In China, the inflation rate climbed to a three-year high of 6.5% in July before receding to 4.2% in November. However, food costs—an important part of the average household budget—still rose 11.9% in October from a year earlier. Over the past 18 months, the Chinese monetary authorities have increased reserve requirements nine times and raised policy rates five times in this tightening cycle before beginning to loosen policy in November.

This tension is exacerbated by rising labor costs and a shrinking supply of workers in coastal areas, which threatens to sap China's export strength, which accounts for more than 20% of GDP. Companies have relocated some production further inland, but it is likely that cheaper locations such as Bangladesh, Indonesia, or Vietnam are also benefitting from some production moving out of China altogether. In response, the Chinese authorities are keen to encourage output to move up the value chain, aided by the return of its graduates from western universities armed with world-class technical skills. There are already complaints from some middle-tier German capital goods manufacturers about Chinese attempts to encroach on their home turf. It is not a large leap from such resistance to the escalation of protectionist measures.

China has been trying to unwind some of the excesses generated by its massive injection of liquidity to counteract the effects of the 2008 western financial bust. Since December 2008, Chinese banks have put $4.1 trillion of new credit on their balance sheets, which has kept growth humming but saddled them with a large amount of loans that may go bad if the growth they were predicated on fails to materialize. It is ironic that in its attempt to offset the fallout of the 2008 crisis, China may have trapped itself on a similar treadmill that it cannot afford to get off.

Some may argue that in spite of a subsequent tightening of policy to take back some of this excess, conditions remain relatively lax, with inflation-adjusted policy rates often remaining negative. Nevertheless, tighter policy—including administrative limits such as higher down payments on real estate purchases—has been effective in cooling off the socially divisive spurt in Chinese real estate prices. However, with real estate construction representing 13% of Chinese GDP last year, a slump could have a noticeable effect on the global economy.

In October, real estate transactions slumped 39% in the 15 largest Chinese cities, compared to a year earlier. The banking regulator warned lenders that some projects could run out of funding and told them to cut high-risk loans to developers. This has affected developers' cash flows, leading to an increase in defaults. At the beginning of the chain, local authorities have found it more difficult to finance their budgets through land sales to developers. Some lenders have also come under stress as loans have turned sour or the value of collateral has been impacted. In September, bank loans grew at their slowest pace since October 2008, and growth in M2 is now well below the 16% target. According to the government, some limited fallout from the cooling down of the real estate market is inevitable and can be controlled, and it aims to lead house prices back to reasonable levels. Partly to compensate, the government has also embarked on an ambitious multiyear program to build 30 million affordable housing units to relieve the pressure of frustrated demand.

Of course, it is difficult to gauge the extent of the risk emanating from this sector, even for the authorities, given the alleged existence of an extensive "shadow banking" system. Nevertheless, some signs of distress did alert investors to the possibility of a Chinese hard landing, inadvertently triggered by excessive policy tightening. Furthermore, the slowdown in real estate construction spells a moderation of demand for raw materials and products such as steel, and so exports from resource-rich countries. It is probably no coincidence that iron ore prices plunged during September.

Despite the slowdown in real estate, the official third quarter growth rate was still a strong 9.1%, and retail sales grew 17.2% in October from a year earlier. However, with finance being squeezed and exports running into headwinds, the government has recently changed its policy bias.

The late November decision by Chinese monetary authorities to cut banks' deposit requirements by 50 basis points (bps) for the first time in nearly three years is the first tangible evidence of policy "fine tuning." This action shows that concerns have now switched from inflation to growth slowdown due to financial stresses at home and the deflationary effect of the European debt crisis. Chinese Purchasing Managers' Index (PMI) data have fallen decisively below the 50 neutral line in October, the weakest since 2009, indicating that the manufacturing sector is contracting, probably as a result of a sharp fall in European demand. Analysts now predict a series of rate cuts and other easing measures over the coming months.

Bulls are sufficiently impressed by the immense reserves of the government, the work ethic of the people, and the ability of the leaders to impose decisions quickly by administrative fiat, without the tedious encumbrance of a democratic process that can result in gridlock or inconsistent policies as each side alternates in power. They also point to the fact that almost all of the banks are state controlled and headed by senior Communist Party officials. Lastly, the government is already encouraging a rebalancing of activity from exports to domestic consumption, and there is plenty of road left to travel in this direction.

On the other hand, bears are more skeptical of the ability of a centrally planned system to successfully manage the economic cycle and micromanage the utilization of liquidity. They point out that prolonged periods of overinvestment are always followed by big busts. China can perhaps afford to pump up its economy one more time with a series of targeted public investments and looser monetary policy. However, this will probably be at the cost of entrenched inflation, with consequences further down the road.

Brazil

Brazil—the second-largest market in the emerging markets universe after China and the largest economy in Latin America—has had a particularly poor 2011, down 13.2% to end November as investors have grown nervous about the policies of President Dilma Rousseff and the economy has cooled rapidly. The market is dominated by natural resource companies that have been de-rated as expectations of a significant global slowdown have formed.

The so-called tripod of policies targeting low budget deficits, a freely floating exchange rate, and inflation control has contributed to the longest period of growth in Brazil since the 1970s. Instead of using 2010's roaring 7.5% growth rate to pare back debt, the government resorted to special accounting rules to meet its primary budget surplus goal. However, inflation reached a seven-year high of 7.2% by August, more than the official target of 4.5% +/-2%, as the central bank had raised rates by 175 bps in 2011 up until that month. The August 31 decision to reverse policy and start cutting rates by 50 bps to 12% due to a deteriorating global economy was seen by some as a politically influenced gamble. Credit growth in September was at the fastest rate this year and domestic demand appears very resilient. Real estate prices in some of the largest cities continue to rise at over 20% per annum. There is skepticism that the stated goal of bringing down inflation to 4.5% in 2012 will be reached, even though economic growth is forecast to slow to around 3.0% this year and 3.5% in 2012, according to the OECD. That said, the surprisingly flat third quarter growth rate shows a rapid deceleration in the economy that could vindicate the central bank's action and presage further cuts in rates. Nevertheless, for some, the central bank has become less predictable as it has added other goals, such as maintaining growth and managing the exchange rate, to its inflation brief.

High real and nominal rates had led to the *real* climbing approximately 50% against the dollar from the end of 2008 to July of this year—a 12-year high—leading to the introduction of capital controls and transaction taxes. The surprise cut in rates triggered a free fall in the currency, which lost roughly 14% of its value in one month, forcing intervention to support the *real* and raising inflationary expectations. Yields on the government's 2021 bond jumped 59 bps in five days around mid-September, even as ten-year U.S. Treasury yields sank to 1.72%. The weakening of the "tripod" and doubts about the central bank's autonomy could increase the risk premium investors demand to hold Brazilian assets.

India

India has struggled this year with high inflation and has been one of the weakest emerging markets. The Reserve Bank of India has raised rates 13 times since March 2010, impacting economic growth, which was 7.7% annualized in the second quarter and 6.9% in the third quarter, the slowest for more than two years. Growth is forecast to come in above 7% next year, with economists expecting rate cuts and reductions in reserve requirements imminently even though current official rates of 8.5% are already negative in real terms. In November, manufacturing growth slowed due to a deceleration in domestic orders, and the PMI fell to 51 from 52 according to Markit. This has raised some concern in a country that has become accustomed to 9% growth rates for a number of years. Even so, inflation has remained high at around 9%. Consequently, India is feeling the dilemma between maintaining high growth while controlling inflation more than most. In recent months, India has also suffered from a weak currency, forcing some intervention to try to smooth the decline. The rupee had tumbled about 15% against the U.S. dollar since the Eurozone crisis erupted again in August. Capital inflows evaporated this year and the benchmark Sensex Index is down over 20%. As the exuberance has washed out of the market, our composite P/E valuation of 15.9 at the end of November is now below the long-term average, but not cheap relative to its emerging markets peers.

Sentiment has also suffered due to the government's failure to overcome an entrenched resistance to opening up to outside investments in certain sectors, as well as a number of corruption scandals. Prime Minister Manmohan Singh's Congress Party–led coalition does not command a safe parliamentary majority, and there is a perception of a weakening determination to continue the structural reforms that have contributed to high growth rates. A government that appears weak may quickly follow populist policies to shore up its support. Slated reforms such as allowing foreign direct investment in the retail and aviation industries are coming up against heated opposition from vested domestic interests, and it is not clear whether the government has the strength to implement them.

Although the economy is expected to slow next year, growth should remain high compared to the developed economies; however, the political issues, stubbornly high inflation, and non-compelling valuations mean that lackluster returns may last a while longer.

Russia

Russia's economic growth accelerated in the third quarter to 4.8% compared to a year ago, despite a stock market slide of close to 9% year-to-date. To some extent, the robust economic performance was a bounceback from the drought-affected conditions of 2010. From July to October, grain transport for export grew about 50% compared with two years ago, but this growth is now stretching the country's railway capacity. Economists have marked down expectations for 2012 growth to 3.7% because of the Eurozone debt turmoil and the slow pace of domestic reform. Industrial production grew only 3.9% in September from the previous year as the crisis in Europe—Russia's most important export market—decreased demand for manufactured goods. The whole economy is expected to return to its pre–2008 crisis level by the end of 2011.

Vladimir Putin, who has announced his 2012 presidential candidacy, has targeted growth to return to the 6% to 7% rates of pre-2008, potentially turning Russia into one of the five largest economies by 2020, especially if the country joins the World Trade Organization next year. Real wages increased 15% per year from 2000 to 2008, but have averaged only 1.5% growth since, undermining support for Putin and his network of business leaders. Whereas past high growth rates were driven by climbing energy prices and, more recently, exports to China, it is uncertain how much these drivers can be replaced by domestic consumption and investment, absent reforms such as further privatizations and a more equitable sharing of the fruits of growth. That said, in the third quarter unemployment fell to a three-year low and retail sales jumped 9.2% in September, boosted by bank lending, while fixed capital investment rose 8.5% from a year earlier. Loan growth may reach 30% this year according to Deputy Economy Minister Andrei Klepach.

Of course, Russia and its markets are still dominated by energy. Russia's budgets enjoyed surpluses from 2000 to 2008, boosted by rising energy prices. With an approximately balanced budget expected for 2011, this surplus will probably deteriorate to a small deficit in 2012, partly due to tax cuts, assuming oil prices do not change much. As a result, the government does have the power to prime the growth pump, unless the global economy slumps again as in late 2008.

It is hardly surprising, therefore, that the Russian equity market still behaves to some extent like a leveraged play on global growth via the energy markets. In the third quarter, when fears of a global slowdown reached their peak and oil prices fell rapidly, the RTS Index plunged approximately 29% in US$ terms as the ruble also fell against the U.S. dollar. Since the market had performed relatively well in the first six months of the year, the third quarter loss brought year-to-date returns through November back to roughly in line with the MSCI Emerging Markets Index.

However, with oil prices up substantially in 2011 and current tight conditions in this market, it is somewhat surprising that Russian equities have not performed better. They remain firmly entrenched in single-digit P/E multiples and have distinguished themselves as being the cheapest equities in the world at various points this year.

Some of this can be explained by the anticipation of pre-election populist measures such as capping the tariffs that domestic utilities can charge while suffering steep increases in wholesale prices. Inevitably, some managers point to the current time as an extraordinarily attractive opportunity to pick up very undervalued stocks. Others will explain the apparent deep discount offered by the Russian market as reflecting skepticism about corporate governance, the rights of minority shareholders, and the rule of law, as exposed during the 2008 crisis. Nervousness about the return of Putin to the presidency in the managed democratic process—given falling popularity ratings and mounting dissatisfaction with a system increasingly viewed as deeply skewed to benefit the "friends of the Kremlin"—is no doubt a key factor. With reports that educated and wealthy Russians are looking to export their assets or leave the country, confidence about the future is low.

Outlook

Emerging markets are still expected to perform well over the long term because of their superior economic growth, strong public finances, low penetration of goods and services among their populations, and low weightings in developed country institutional portfolios. Capitalization of equity markets relative to their economies is far lower than in developed markets, and public balance sheets and fiscal positions provide ample firepower to soften any cyclical downturn.

Of course, superior economic growth does not necessarily translate into superior investment returns. If investors buy in at expensive valuations, then returns will disappoint. Also, one should never underestimate the willingness of businesses to issue new equity to satisfy rising and sometimes less-discriminating investment demand. Consequently, faster-growing earnings may not translate into EPS, particularly if accounting and legal standards are not commensurate with more established markets.

At the time of this writing, we regard valuations as at the low end of fair value. Normalized P/E and P/B ratios are back down from the relatively high levels of 2010 and stand at a slight discount to developed markets valuations, but at less of a discount than the historical average, which is obviously overstated by the excessively high valuations of developed markets during the bubble years that cover much of the period for which we have data. Still, emerging markets equities have been de-rated compared to their own long-term valuations, so caution has come into these markets, which is encouraging from a long-term investor perspective. This reflects the clouds on the short-term horizon emanating from Europe, as well as the dilemma of choosing between maintaining high growth and bringing down inflation. Furthermore, the relative performance momentum of emerging markets against developed markets has come down to an attractive level.

China remains the pivotal country, due to its economic and market weight, and its effect on the growth of other countries such as Brazil and Russia, as well as developed markets.

For now, we suspect that everything possible will be done to ensure a soft landing in China ahead of the expected leadership changes at the next Party Congress in 2012, which probably translates into maintaining a growth rate of at least 8%. Some might quip that it is time to switch out of "Bernanke puts" into "Zhou puts" (chairman of the People's Bank of China) given this backdrop.

While this may be auspicious for risk assets over the next 12 months, it also begs the question of whether China is repeating the same mistakes that led to the recent debacle in developed economies. At what point does the priming of the pump to maintain a high growth rate become ineffective, and can an orderly slowdown be engineered?

A similar picture prevails in other important emerging markets countries. Whether democratic or centrally controlled, governments appear intent on maintaining historically high growth rates, even at the risk of inflation. In Russia, 2012 is a key political transition year, and barring any unforeseen upset, we expect the leadership to engineer favorable economic conditions (assuming no deep fallout from an imploding Eurozone). On the merits of emerging markets alone, valuations are reasonable and governments seem poised to support growth, even at the potential risk of higher inflation. The key risk to these markets in the near term is if developed markets ignite a more serious recession than what appears to be priced in at present.

Conclusion

Investors are being cautious about emerging markets given weak growth in developed markets, a slowdown in China and Brazil, and persistent inflation in some countries. Such a cooling of sentiment—combined with the substantial outflows from these markets during 2011 and lower valuations—encourages us to turn more positive on emerging markets.

Much of the bad news with respect to European debt has been factored in by now, including a probable Eurozone recession over the coming months. It would not take much "less bad" news from this quarter to tempt marginal investors away from the negative real returns of so-called risk-free cash and bonds. In the United States, there are signs that the economy is not slipping back into recession. Emerging markets governments and central banks are being quick to fine-tune policy to compensate for developed markets weakness in demand and maintain high growth in the important political transition year of 2012.

At current reasonable valuations, we are relatively favorably disposed toward emerging markets from a long-term perspective, but are aware that even the positive short-term outlook could still be scuppered by worse-than-expected outcomes.

The Eurozone debt problem is the prime candidate for destabilizing influence. Although talk of disorderly sovereign defaults and/or some form of breakup of the Eurozone may be somewhat alarmist, such an eventuality cannot be fully discounted, and its likelihood rises as policymakers remain indecisive and sovereign rates remain volatile and elevated. As in 2008, it is unlikely that emerging markets would be able to decouple from the consequences of such a disaster.

Second, there is always the possibility of rising geopolitical tension, if not crisis. The principal candidate here is the Middle East, as the chain of events set off by the "Arab Spring" could lead to shifts in policies in the region. Even without such changes, rising tensions with Iran and potential oil embargoes (echoes of the 1970s?) could disrupt an oil market with little effective spare capacity.

Further down the line, investors should keep in mind the possible rise of protectionist pressures if developed markets do not recover at an adequate rate. At this stage, we cannot judge how well the ruling elites in some of these markets (Russia and China) will be able to evolve their power structures in the face of a growing and restless middle class. There is also circumstantial evidence that the newly wealthy Chinese and Russians are searching for a haven for their wealth outside of their home countries, meaning that insider money may not be invested right now.

Should the delicate balancing act of keeping growth on the boil, sharing enough of the spoils with the population at large, and keeping a lid on destabilizing inflation break down, disruptive political change could bring down valuations to truly attractive levels. However, at least in the short term, our central view is that the governing elites of those countries expecting political handovers in 2012 will succeed in keeping the show on the road at least over the coming year. There is no guarantee that the long-awaited Chinese hard landing will occur anytime soon.

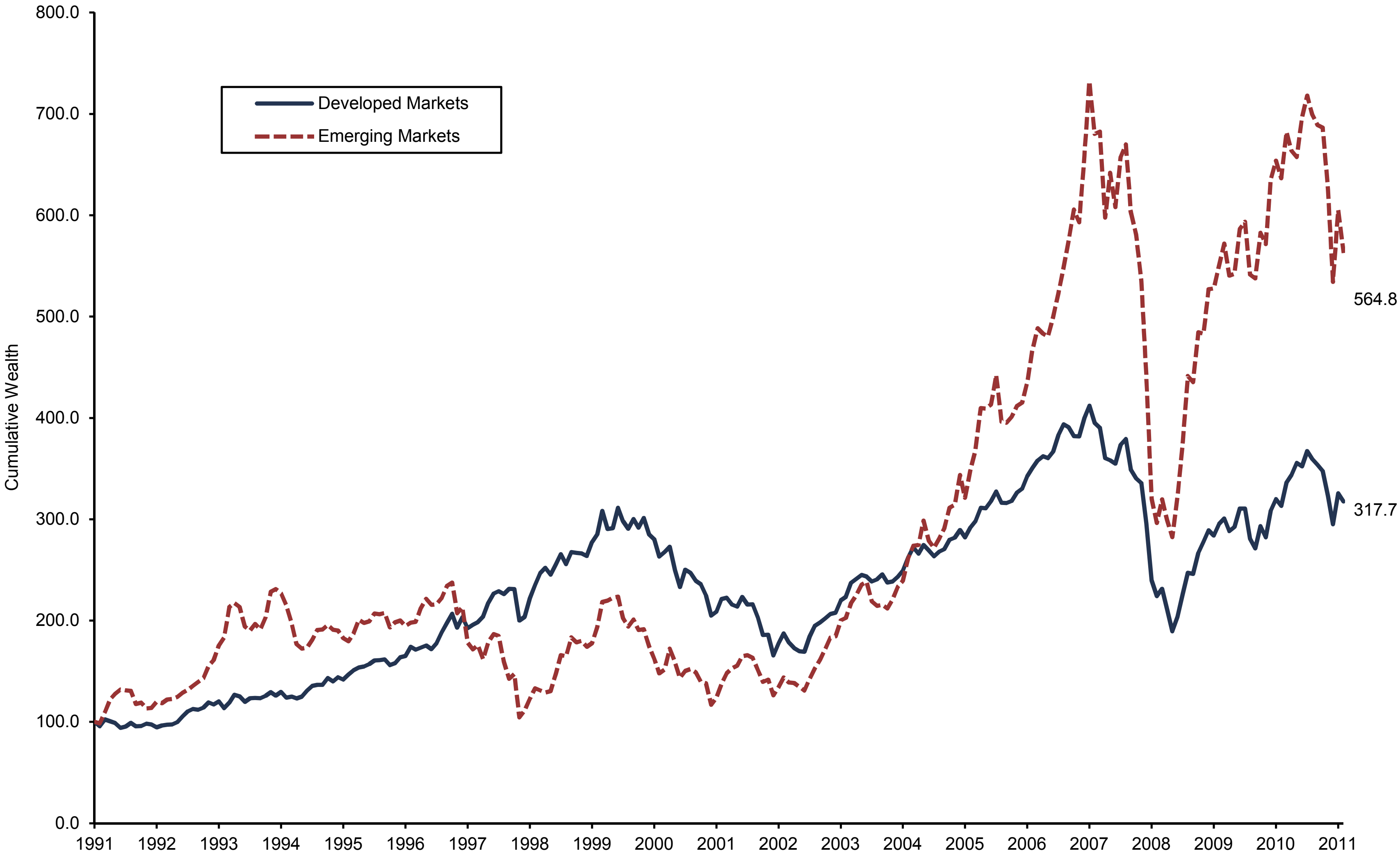
At the same time, investors should not treat emerging markets as a homogenous group. The cultural, demographic, and economic profiles of the countries within this heterogeneous asset class are very diverse. Some countries are more at risk economically or politically than others, so it is a classic case where implementation of exposure using an index-agnostic active manager is likely to bring superior returns compared to a passive alternative or index-hugging large-cap "active" manager. Further complicating matters, many of the skilled active managers with the resources to adequately research this extensive universe are closed to new investments. Should a market shakeout temporarily free up capacity, investors should be poised to take advantage quickly with targeted managers.

Our current pro–emerging markets stance is valuation sensitive, and such measures can change quickly in today's volatile markets. As emerging markets trade close to a neutral valuation relative to developed markets and slightly below their own historical multiples, we recommend that investors that are underweight emerging markets rebalance toward their central policy target. We recognize that emerging markets tend to be a higher beta play on equities, which, in the current malaise, means they should be treated with caution. However, given the lower debt levels, relatively cheap valuations would compensate to some degree for this risk. Should emerging markets valuations move back into overvalued territory, we would likely change our advice (other things being equal) as we anticipate continuing bouts of volatility for a period of time as countries grapple with underlying economic and political issues. ■

Exhibit 1

Developed and Emerging Markets Equity Total Return Performance

October 31, 1991 – November 30, 2011 • Rebased at 100 at October 31, 1991 • U.S. Dollar

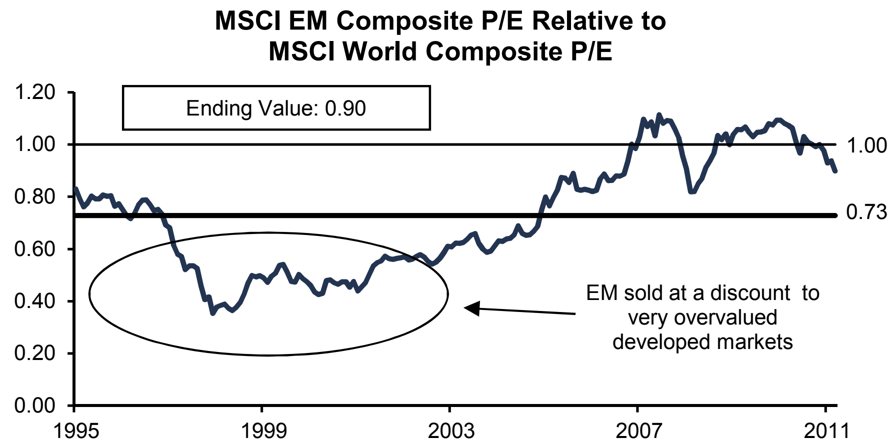


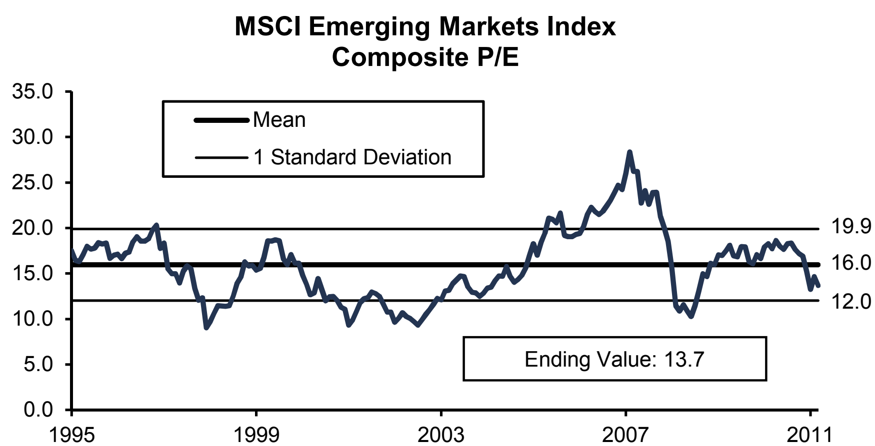
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Total returns for MSCI emerging markets indices are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes.

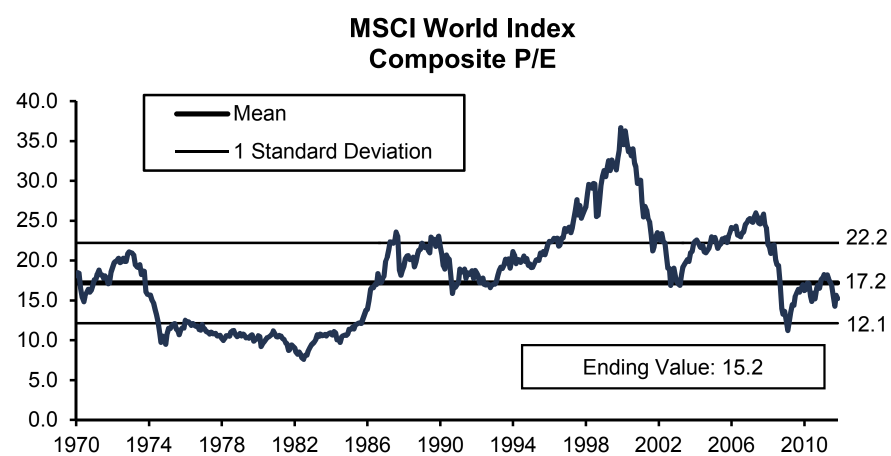
Exhibit 2

Composite Normalized Price-Earnings Ratios: MSCI Emerging Markets Versus MSCI World

September 30, 1995 – November 30, 2011





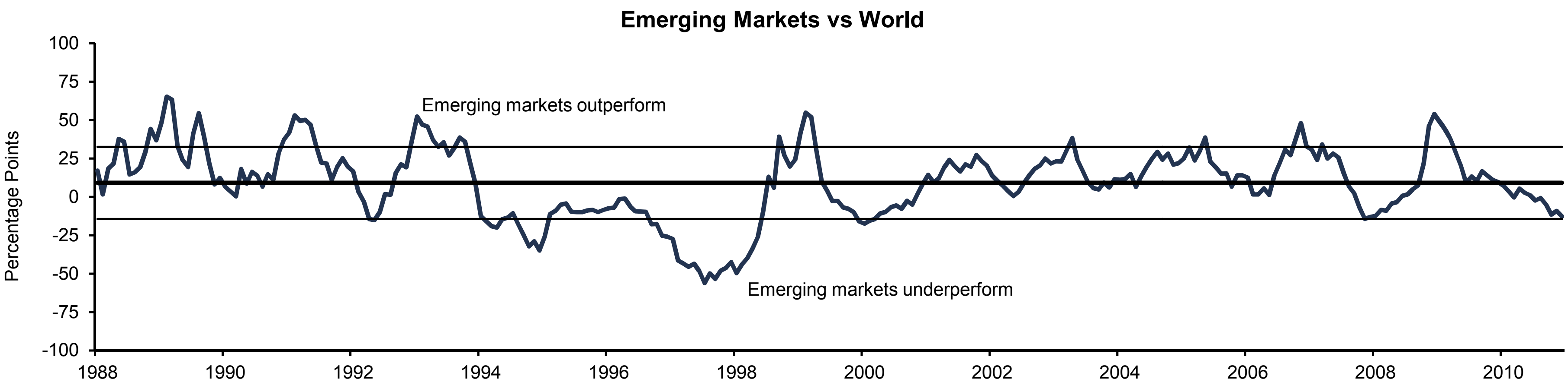


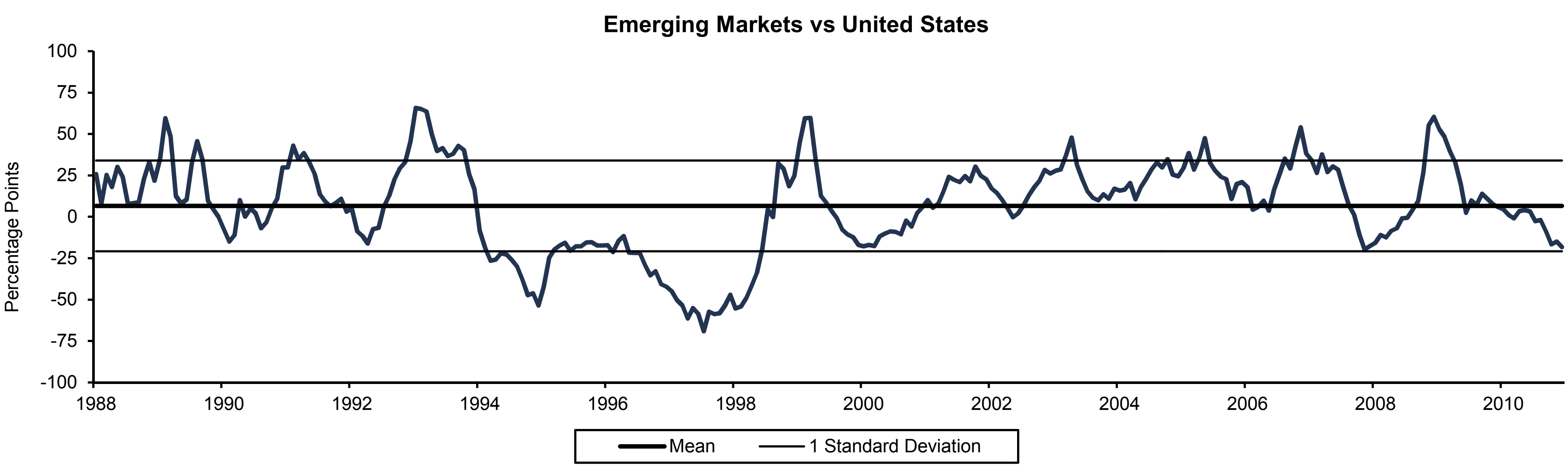
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The composite normalized price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity (ROE)–adjusted earnings. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to its historical norm. Shiller P/E is calculated by dividing the current price level by the ten-year average of inflation-adjusted earnings per share. Trend-line P/E ratios compare current stock prices to the level of earnings predicted by long-term real earnings growth based on a simple linear regression. MSCI World composite normalized P/E data begin January 1970.
1864m (mod)

Exhibit 3

Rolling 12-Month Relative Performance

December 31, 1988 – November 30, 2011 • U.S. Dollar





Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Graphs show the percentage point difference between the rolling 12-month total return of emerging markets and each market in U.S. dollars. Total returns for MSCI emerging markets indices are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes.

Exhibit 4

Emerging Markets Total Return Performance Relative to Developed Markets

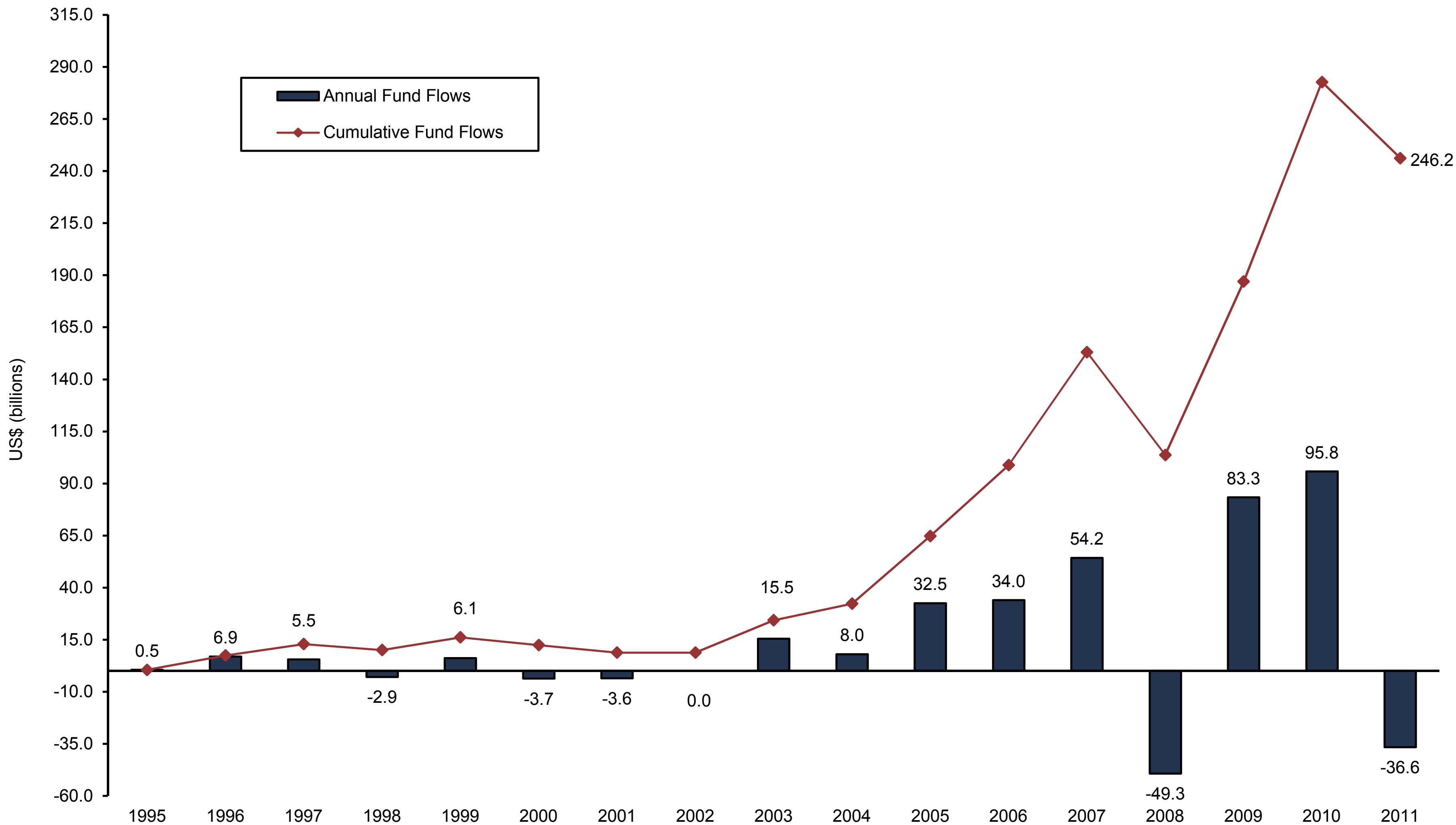
December 31, 2006 – November 30, 2011 • Local Currency

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Index levels are rebased to 100 as of December 2006. Total returns for MSCI emerging markets indices are gross of dividend taxes. Total returns for MSCI developed markets indices are net of dividend taxes.

Exhibit 5

Net Annual and Cumulative Inflows into Emerging Markets Funds

1995–2011



Sources: EPFR Global and Morgan Stanley Research.

Notes: Fund flows cover all dedicated emerging markets equity funds. Data for 2011 are through November 30.

1865m

Exhibit 6

Major Emerging Markets Country Economic and Equity Valuations Data

As of November 30, 2011

	China	Brazil	Korea	Taiwan	South Africa	India	Russia	Mexico	Malaysia	Indonesia	Average	Total	**MSCI EM**	**MSCI World**
Market Cap (US$ millions)	546,945	496,343	489,410	343,454	259,622	212,971	227,748	154,944	111,474	93,639	---	2,936,550	---	---
MSCI EM Index Weight	16.8%	15.3%	15.1%	10.6%	8.0%	6.6%	7.0%	4.8%	3.4%	2.9%	---	90.3%	---	---
PPP GDP (US$ billions)	10,243	2,179	1,418	899	526	4,197	2,232	1,834	417	1,033	---	24,977	---	---
GDP Growth 2011*	9.1%	3.0%	3.9%	4.4%	3.1%	7.9%	4.0%	3.4%	4.5%	6.5%	5.0%	---	---	---
GDP Growth 2012*	8.2%	3.5%	3.9%	3.1%	3.6%	7.8%	3.7%	3.1%	4.4%	6.3%	4.8%	---	---	---
Gov't Debt as % of GDP 2011*	26.9%	65.0%	32.0%	38.5%	36.1%	62.4%	11.7%	42.9%	55.1%	25.2%	39.6%	---	---	---
2011 Budget Balance as % of GDP*	-1.8%	-2.7%	2.4%	-2.7%	-5.5%	-5.4%	-0.8%	-2.9%	-5.6%	-1.0%	-2.6%	---	---	---
2011 Current Account as % of GDP*	2.9%	-2.2%	2.0%	8.0%	-4.1%	-3.5%	5.0%	-1.9%	10.4%	0.4%	1.7%	---	---	---
Policy Rate	3.6%	11.5%	3.3%	1.9%	5.5%	8.5%	5.3%	4.4%	3.0%	6.0%	5.3%	---	---	---
Benchmark Gov't Bond Yield	3.6%	11.1%	3.8%	1.3%	7.9%	8.7%	8.3%	6.2%	3.7%	6.9%	6.2%	---	---	---
Inflation (YoY NADJ)	6.1%	7.3%	4.3%	1.4%	5.7%	10.1%	7.2%	3.1%	3.4%	4.6%	5.3%	---	---	---
Earnings Growth 2012*	12.3%	8.3%	16.6%	22.1%	26.0%	15.7%	-3.6%	14.5%	15.4%	14.1%	14.1%	---	---	---
Dividend Yield	3.3%	3.7%	1.3%	4.9%	3.1%	1.4%	2.2%	1.2%	2.9%	2.5%	2.7%	---	---	---
Earnings Yield	11.2%	10.3%	10.3%	7.2%	5.9%	6.8%	18.4%	4.6%	6.3%	6.8%	---	---	---	---
YTD USD Index TR Performance	-20.2%	-20.0%	-10.2%	-22.5%	-12.5%	-33.2%	-9.7%	-10.3%	-3.7%	3.0%	---	---	-17.2%	-5.5%
YTD LC Index TR Performance	-20.2%	-13.2%	-9.6%	-19.3%	7.1%	-22.0%	-9.1%	-1.3%	-0.8%	4.2%	---	---	-12.5%	-6.0%

Sources: J.P. Morgan Securities, Inc., MSCI Inc., and Thomson Datastream. MSCI data are provided "as is" without any express or implied warranties.
Notes: Benchmark government bond data are ten-year bond yields. Inflation data are as of September 2011. Negative budget balance as a percent of GDP indicates budget deficits. Earnings growth figures are consensus estimates for 2012. Data from J.P. Morgan are estimates.
* Forecast.

Exhibit 7

MSCI Emerging Markets Equity Declines and Subsequent Rallies

January 1, 1988 – November 30, 2011 • U.S Dollar

Date of Peak	Date of Trough	Peak to Trough	Decline (Months)	Subsequent Rally	Subsequent Rally (Months)
August 1, 1990	January 16, 1991	-31.9	5.5	101.8	15.0
April 17, 1992	August 24, 1992	-19.3	4.2	97.3	17.6
February 11, 1994	May 9, 1994	-19.5	2.9	29.4	4.3
September 16, 1994	March 9, 1995	-32.6	5.7	44.2[1]	28.0[1]
July 9, 1997	January 12, 1998	-38.2	6.1	24.9	2.4
March 27, 1998	September 10, 1998	-46.4	5.5	124.8	17.0
February 10, 2000	September 21, 2001	-53.7	19.4	48.2	6.9
April 18, 2002	October 9, 2002	-28.8	5.7	91.7	18.1
April 12, 2004	May 17, 2004	-20.4	1.1	122.6	23.7
May 8, 2006	June 13, 2006	-24.5	1.2	101.2	16.5
October 29, 2007	October 27, 2008	-66.1	12.0	33.7	2.3
January 6, 2009	March 2, 2009	-21.8	1.8	154.0	26.0
May 2, 2011	September 26, 2011	-29.4	4.8	9.0[2]	2.1[2]

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

Notes: Bear markets are defined as a price decline of at least 19%. Analysis based on daily data from January 1, 1988, through November 30, 2011. The graph is displayed in logarithmic scale.

[1] The EM Index did not fully recover from its peak of 587.11 on September 16, 1994, until it reached 588.68 on February 28, 2005—a span of 125.4 months.

[2] Represents the rally to November 30, 2011, but does not imply the market has reached its peak.

524m

Exhibit 8

MSCI Emerging Markets Index Economic Sector Allocations and Performance

Periods Ended November 30, 2011 • Local Currency

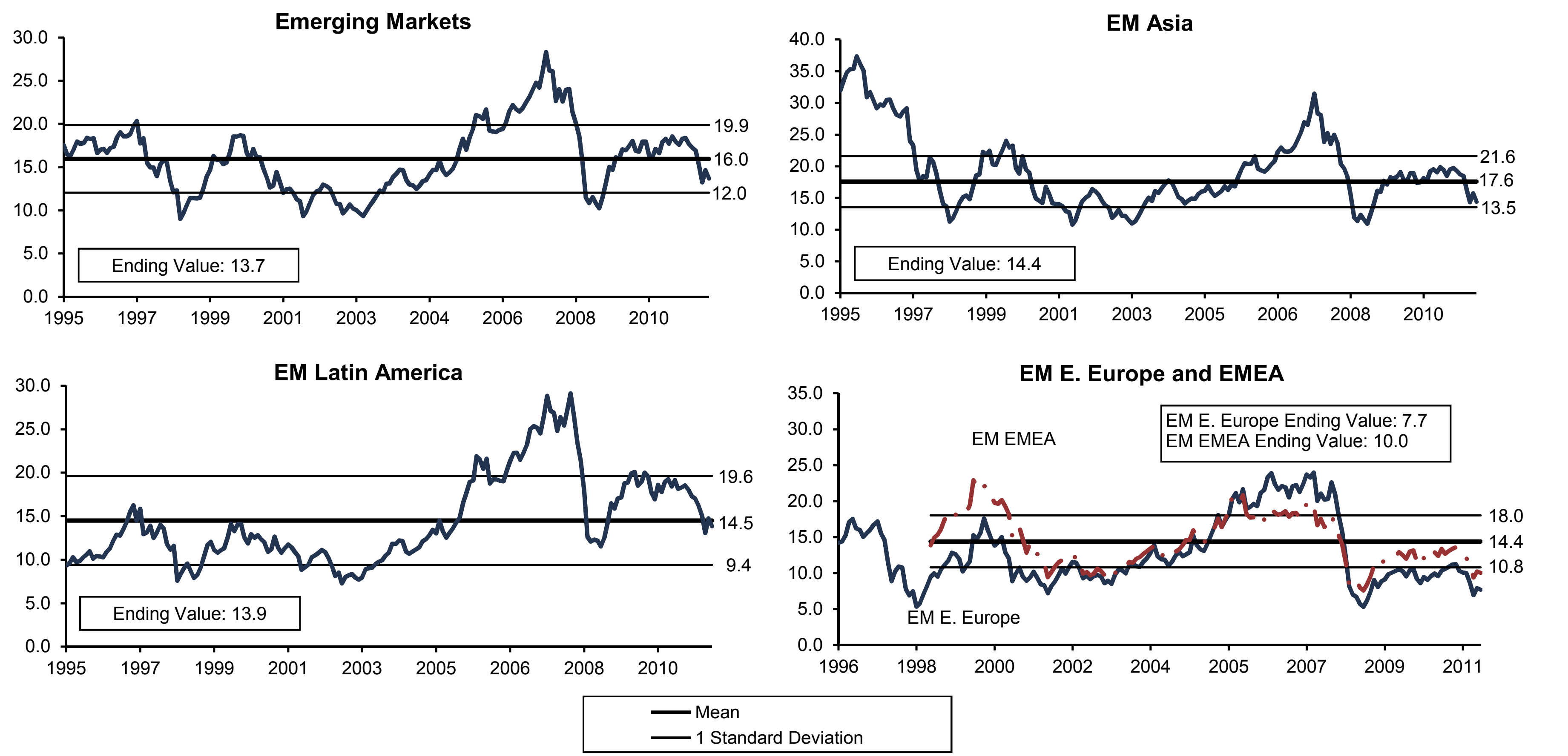
		Total Return (%)				Average Annual Compound Return (%)	
Economic Sector	Percentage of MSCI EM	One Month	Three Months	Cal YTD	One Year	Three Years	Five Years
Consumer Discretionary	8.1	-4.5	-2.2	-1.5	0.1	36.7	10.6
Consumer Staples	7.8	2.1	5.0	8.0	11.0	29.1	15.9
Energy	14.6	-1.1	0.3	-9.8	-2.2	18.0	1.0
Financials	23.3	-7.1	-7.5	-19.4	-17.2	17.4	2.3
Health Care	1.0	-2.8	-1.6	-12.6	-11.9	14.2	8.8
Industrials	6.5	-7.2	-8.7	-25.0	-22.2	14.8	1.4
Information Technology	12.8	-4.0	4.4	-13.8	-7.5	23.6	1.1
Materials	13.7	-5.7	-8.5	-18.3	-13.1	22.4	6.1
Telecommunication Services	8.5	0.6	0.0	3.8	6.1	12.7	7.0
Utilities	3.6	0.4	2.4	-8.3	-6.9	10.0	4.7
MSCI Emerging Markets	**100.0**	**-3.8**	**-2.9**	**-12.5**	**-8.5**	**19.5**	**4.2**

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Percentages may not total due to rounding. MSCI Emerging Markets includes Brazil, Chile, China, Colombia, the Czech Republic, Egypt, Hungary, India, Indonesia, Korea, Malaysia, Mexico, Morocco, Peru, the Philippines, Poland, Russia, South Africa, Taiwan, Thailand, and Turkey. Total returns for MSCI emerging markets indices are gross of dividend taxes.
764m

Exhibit 9

MSCI Emerging Markets Regional Composite Normalized P/E Ratios

September 30, 1995 – November 30, 2011



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

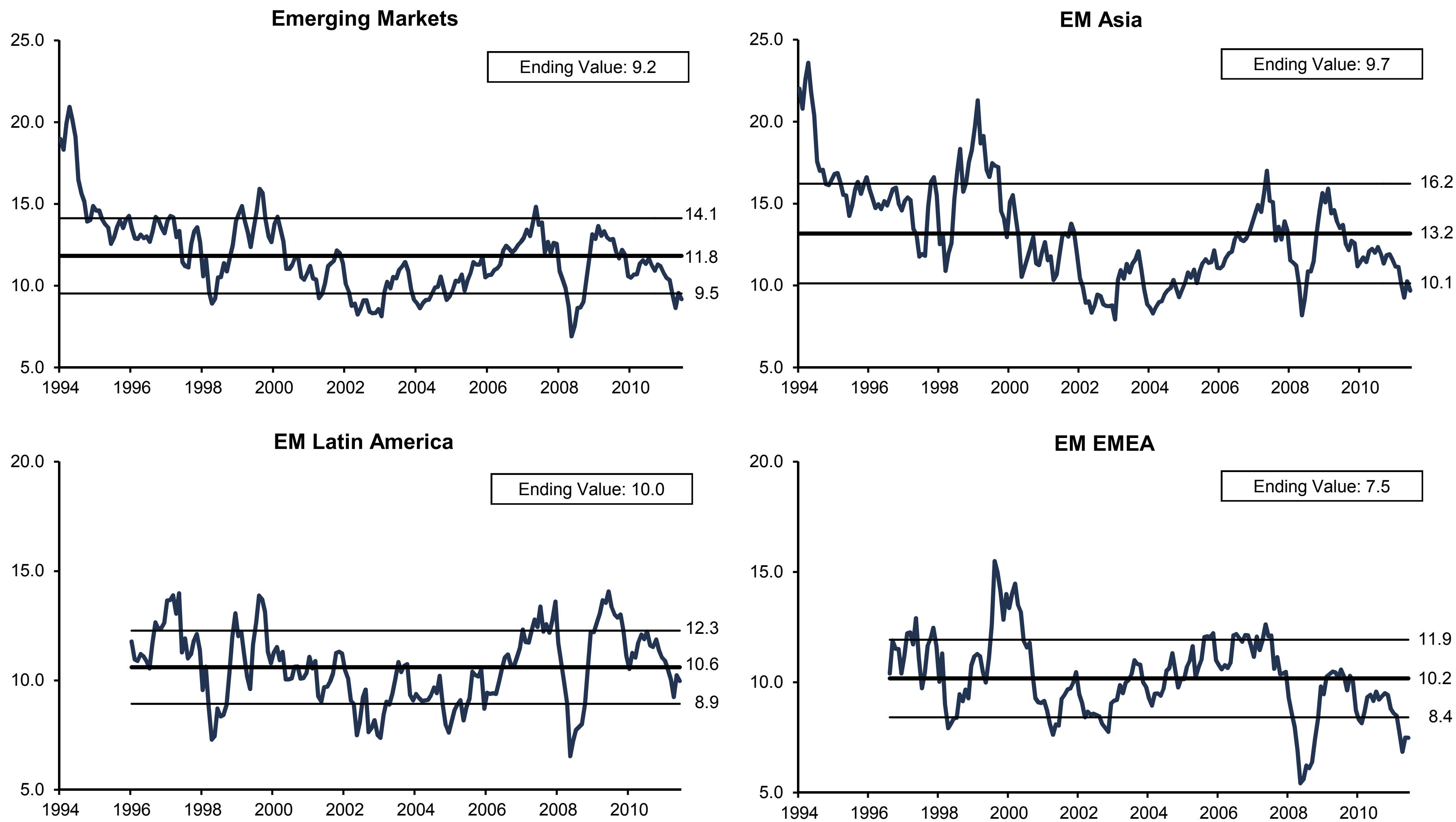
Notes: The composite normalized price-earnings (P/E) ratio is calculated by dividing the inflation-adjusted index price by the simple average of three normalized earnings metrics: ten-year average real earnings (i.e., Shiller earnings), trend-line earnings, and return on equity (ROE)–adjusted earnings. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to its historical norm. Shiller P/E is calculated by dividing the current price level by the ten-year average of inflation-adjusted earnings per share. Trend-line P/E ratios compare current stock prices to the level of earnings predicted by long-term real earnings growth based on a simple linear regression. Mean and standard deviation values on EM Asia exclude valuations prior to December 1997. Mean and standard deviation values on EM Eastern Europe/EM Europe, the Middle East, and Africa (EMEA) graph refer to EMEA. Data for EM Eastern Europe and EM EMEA begin on October 31, 1996, and December 31, 1998, respectively.

916m (mod)

Exhibit 10

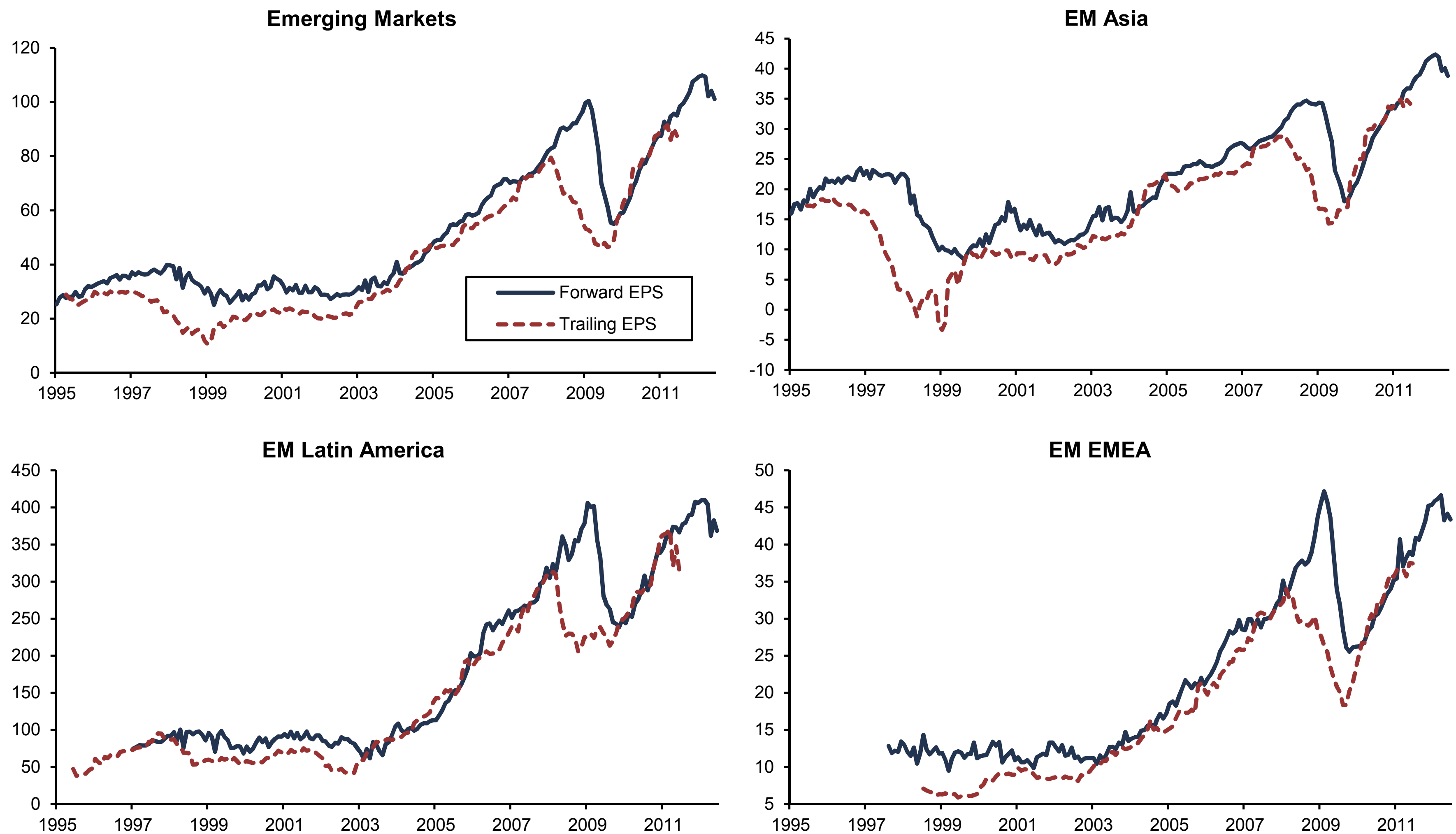
Forward Price-Earnings Ratios

June 30, 1994 – November 30, 2011



Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.
Note: Data for EM Latin America and EM Europe, the Middle East, and Africa (EMEA) begin on June 30, 1996, and January 31, 1997, respectively.

Exhibit 11
Forward Earnings Estimates
June 30, 1995 – November 30, 2011

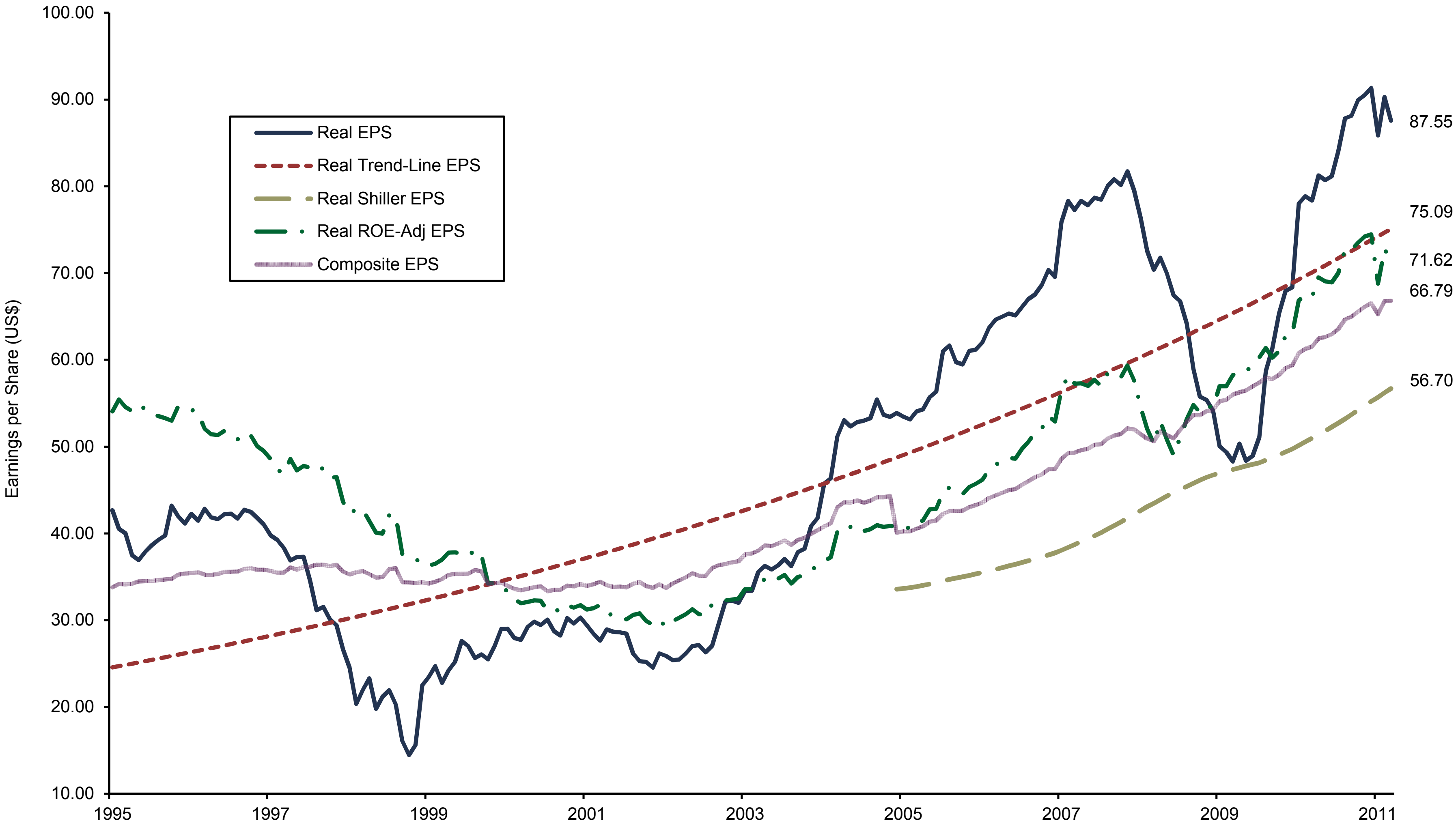


Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.
Note: Forward earnings per share are graphed leading by 12 months.

Exhibit 12

Emerging Markets Earnings Analysis

September 30, 1995 – November 30, 2011

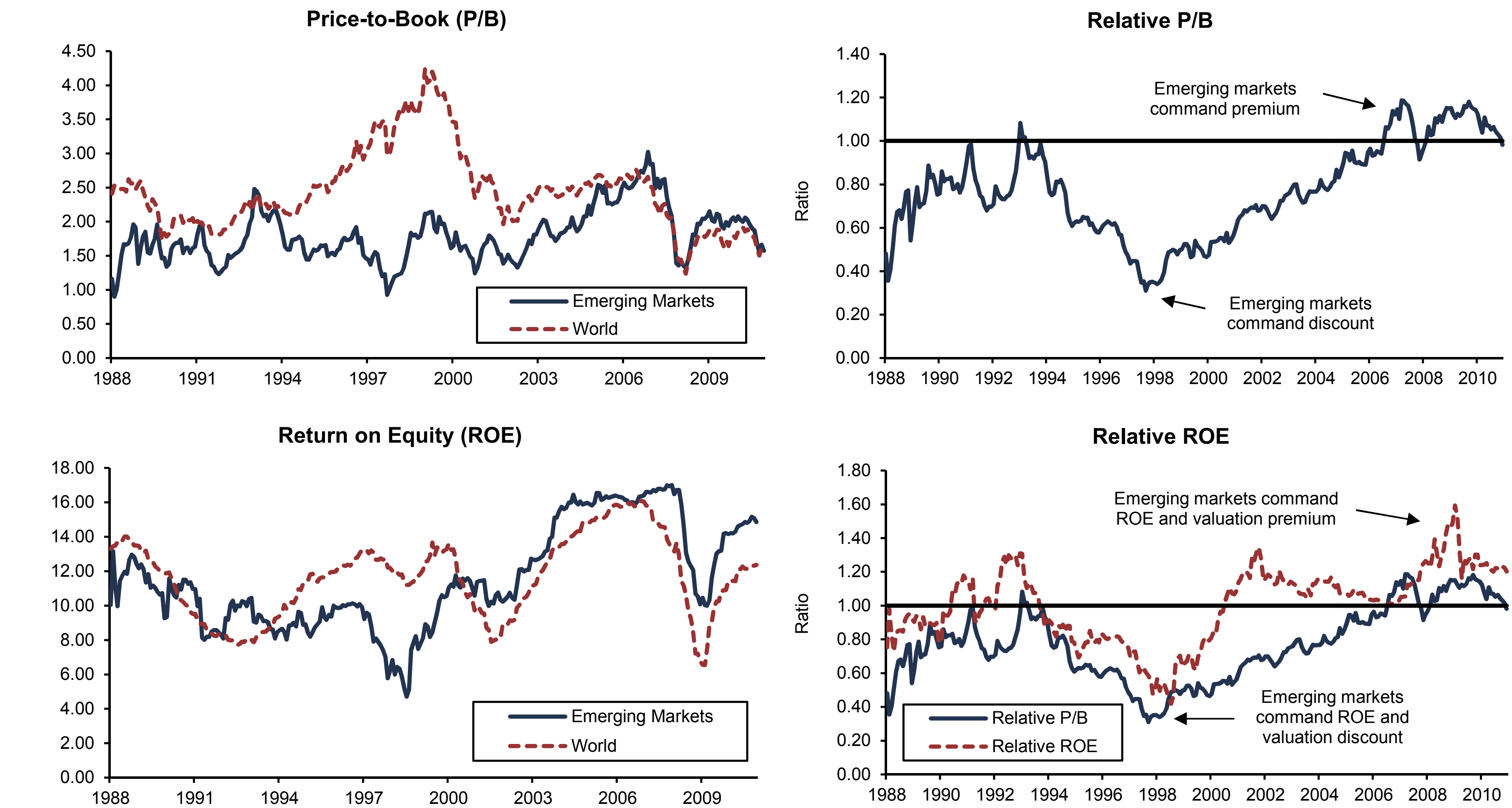


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Composite earnings per share (EPS) are calculated by taking a simple average of real trend-line EPS, real Shiller EPS, and real return on equity–adjusted EPS. All data are in U.S. dollars.

Exhibit 13

Emerging Markets Relative Valuation

December 31, 1988 – November 30, 2011

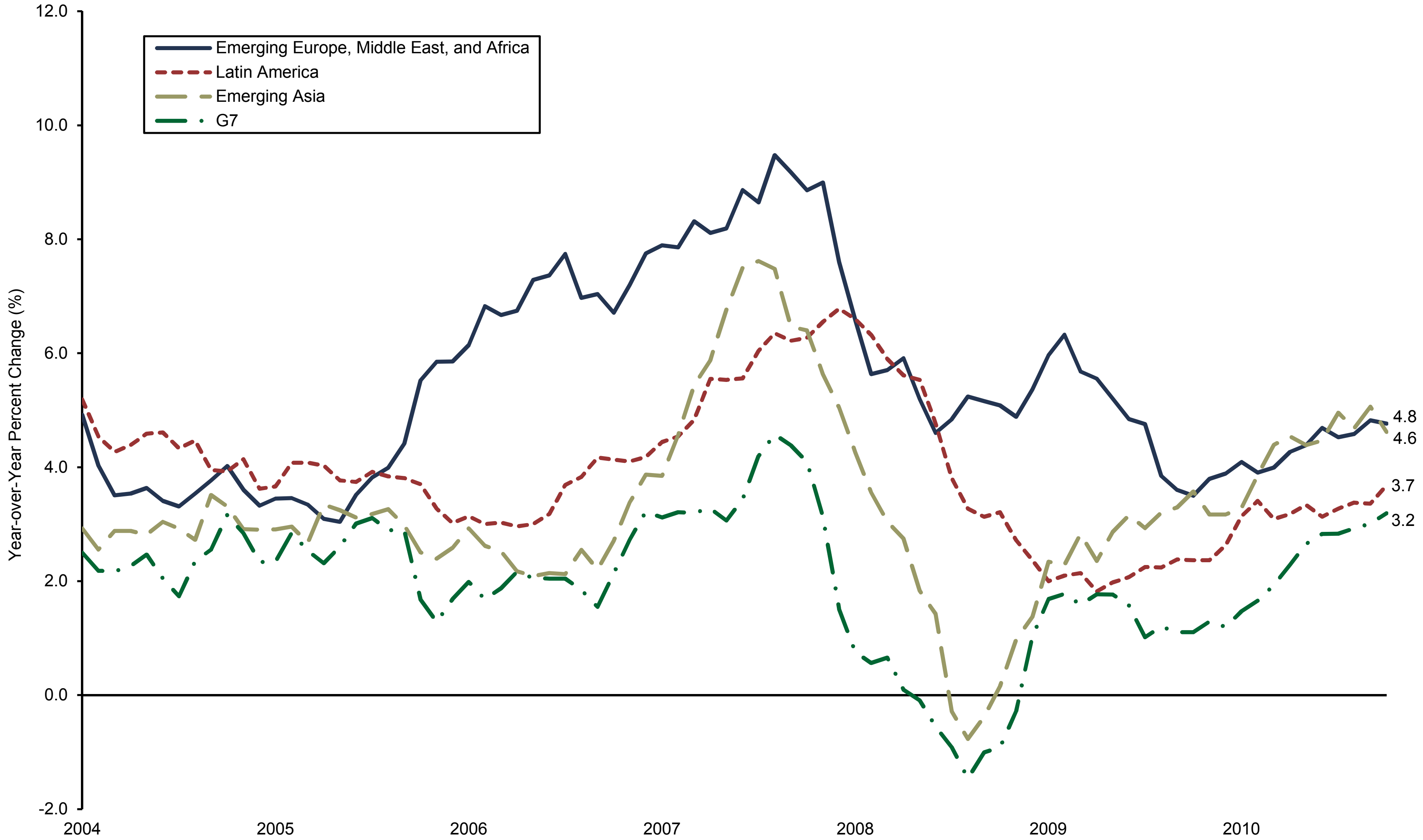


Sources: MSCI Inc., Standard & Poor's, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Relative valuation graphs show MSCI Emerging Markets Index valuation as a percentage of MSCI World's valuation. For emerging markets valuations, the S&P IFCI Composite Index is used until August 1995; the MSCI Emerging Markets Index is used thereafter.

Exhibit 14

Regional Median Headline Inflation Trends

December 31, 2004 – September 30, 2011

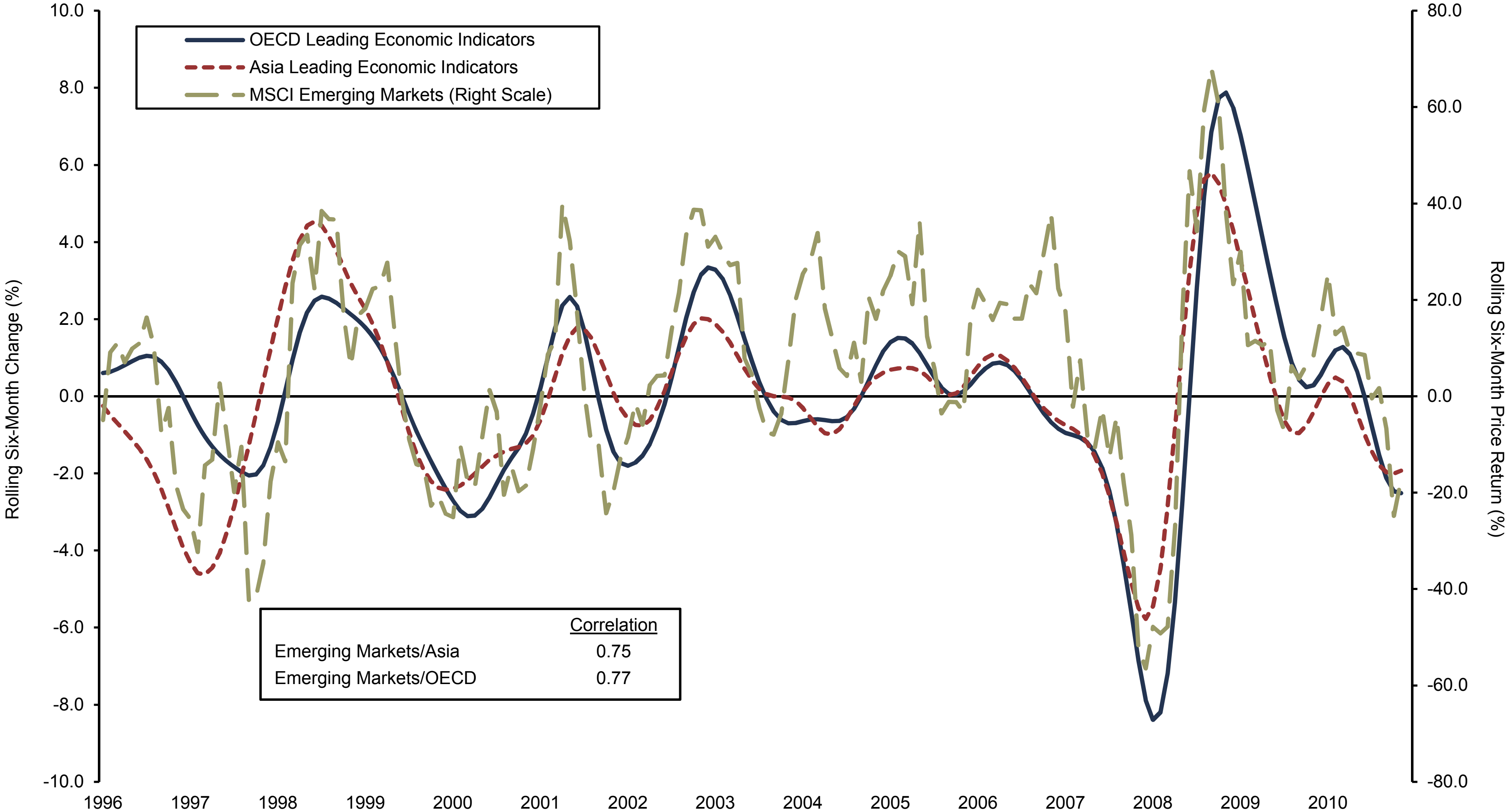


Sources: OECD and Thomson Datastream.
Notes: Inflation data for Chile are as of August 2011. G7 data provided by the OECD.

Exhibit 15

Emerging Markets Price Return Versus Leading Economic Indicators

December 31, 1996 – November 30, 2011



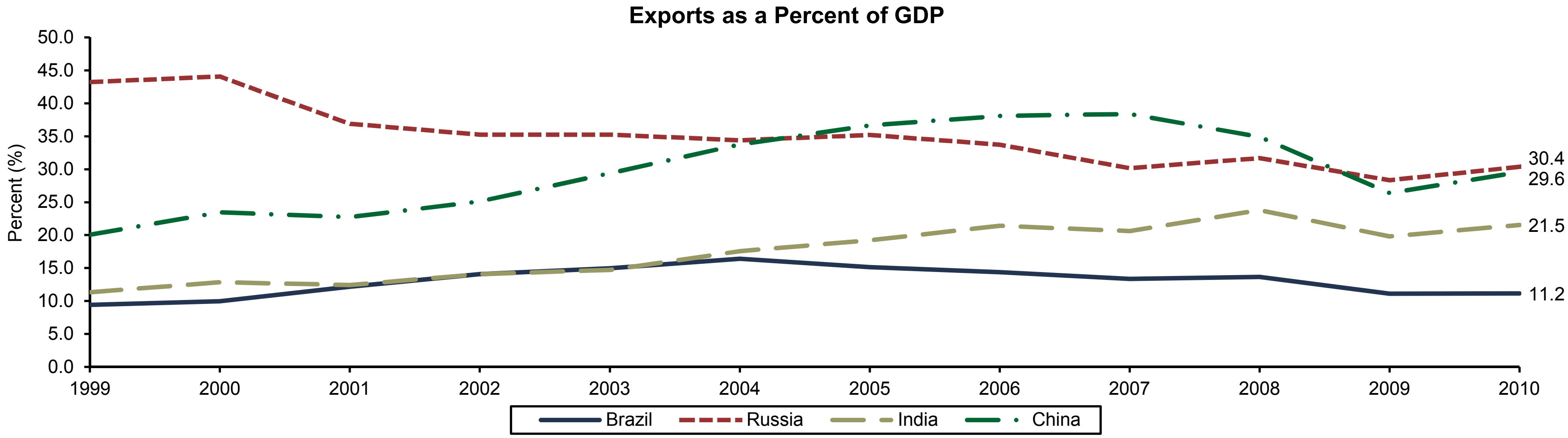
	Correlation
Emerging Markets/Asia	0.75
Emerging Markets/OECD	0.77

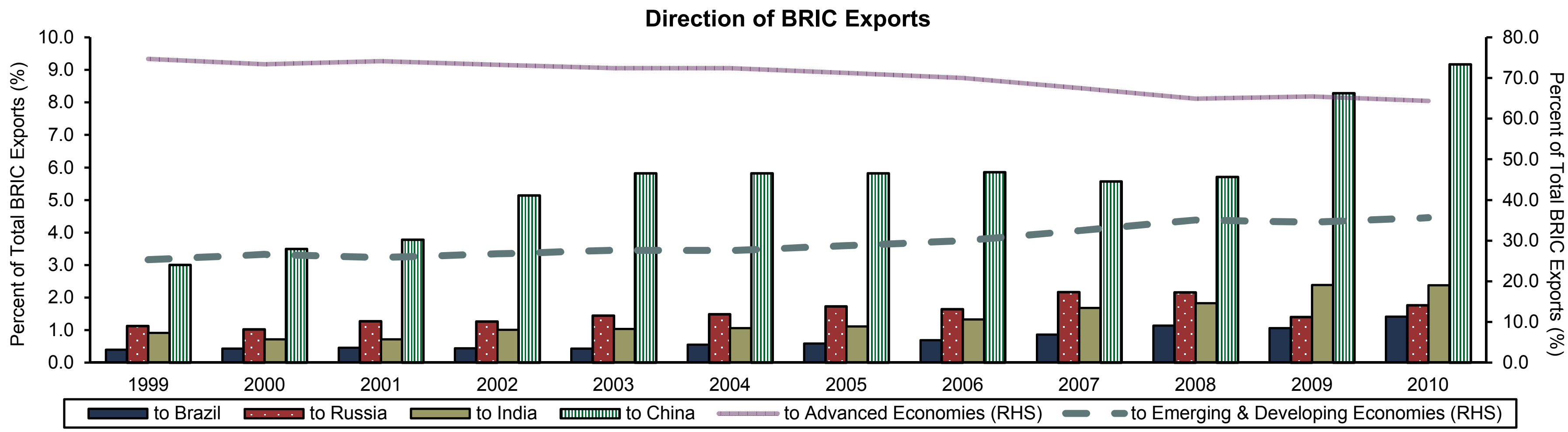
Sources: MSCI Inc., OECD, and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: The OECD composite of leading indicators covers a wide range of economic indicators designed to signal turning points in the economic cycle. OECD composite covers 29 economies, including the Eurozone, Japan, the United Kingdom, the United States, and other members of the OECD. The Asia leading indicators data cover China, India, Indonesia, Japan, and Korea. Data for OECD and Asia leading indicators are through October 2011.

Exhibit 16

BRIC Exports

1999–2010





Sources: Economist Intelligence Unit, International Monetary Fund - Direction of Trade Statistics, and Thomson Datastream.