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CAMBRIDGE ASSOCIATES LLC

EMERGING MARKETS COMMENTARY

EMERGING MARKETS: BUY THE DIP OR FADE THE RALLY?

August 2008

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Emerging Markets: Buy the Dip or Fade the Rally?

Last November we advised investors to tactically reduce their exposure to emerging markets equities as we felt a shakeout in the magnitude of 30% was likely given our view that U.S. and global growth were poised to slow sharply while sky-high emerging markets valuations were not discounting any such notion.[1] At that time, religious zeal regarding the "decoupling" thesis had driven emerging markets equities to trade at a valuation premium to developed markets (historically a red flag), with emerging markets equities being viewed as a safe-haven asset, especially in light of the rapidly depreciating US$. Since then it seems the faithful have turned apostate, with emerging markets equities suffering US$23 billion in net outflows year-to-date (Table A), and the MSCI Emerging Markets Index down 30% from its October 2007 high. Tellingly, while most developed markets have enjoyed a small bounce since mid-July, emerging markets equities slid to fresh lows in August, accelerating a trend of relative underperformance in place since May (Table B).

Since the fall from grace has purged emerging markets equities of their relative overvaluation, is now an attractive time to load back up? We think not. With global economic conditions likely to deteriorate further, we expect emerging markets equities to remain under pressure. And although valuations have improved, strong earnings growth expectations remain priced into shares, suggesting further room for disappointment. Moreover, should emerging markets economies *not* slow appreciably, inflation concerns may resurface, creating an equally strong headwind for shares.

We judge the secular, strategic case for emerging markets equities remains sound, but is now facing a major test that may shake the faith of other acolytes before the global downturn has run its course. Nevertheless—conscious of the fallibility of any and all forecasts—we would advise investors that now find themselves with drastic underweighting in emerging markets to rebalance to their tactical target allocations in case our assumption about slowing global growth proves wrong and/or our inflation fears are unfounded. Moreover, if U.S. equities continue to outperform, we would recommend that investors with sufficient tolerance for volatility continue rebalancing to rebuild positions in emerging markets—difficult though this may be if markets keep sliding lower.

A Survey of the Damage

Tables C–E show the pain thus far, with most every country in the MSCI Emerging Markets Index down by over 20% (a technical bear market), while erstwhile darlings China and India have fallen over 35%,[2] and even commodity-heavy Brazil and Russia have lost nearly one-third of their value. Since last year's peak, Asian equities have borne the brunt of the pain, while Latin America and other commodity producers actually broke to new highs earlier in the summer before the decline in commodity prices ravaged their shares. Indeed, this relative shift has seen Brazil grow to become the largest emerging market in the index on the back of rising commodity prices and the steady implosion of the Chinese stock market.

[1] Please see our November 2007 Market Commentary *Emerging Markets: What To Do, What To Do ….*
[2] The domestic Chinese A-share market, which is largely closed to foreign investors, has plummeted some 60% since last year, while Hong Kong–listed H shares, which compose the MSCI China Index, have declined 47%.

As we noted back in November 2007, a Merrill Lynch fund manager survey showed most managers were at that time underweight China and India in favor of Brazil and Russia, which means they probably fared very well this year, unless they have been blindsided by the reversal in commodities. Defensive managers have been overweight the domestic demand sectors, which had been out of favor for much of the post-2003 rally. Indeed, health care, consumer staples, and utilities have seen the smallest losses, while financials, industrials, information technology, and materials have been hardest hit, and have the highest representation in Asia. In fact, industrials have been the worst-performing segment of the emerging markets universe, down some 41%, although given the financial sector's greater weight, it has accounted for more of the aggregate index loss (Table E).

All in all, despite the sharp pull back, emerging markets equities are only back to their March 2007 levels. In other words, the "correction" thus far has simply erased the gains in emerging markets equities seen since the credit crisis first erupted, purging the euphoric rise based on the now seemingly quaint notion of decoupling. Today, it is clear that much of that previous surge was not based on fundamentals, but was instead a speculative blow-off that accompanies most market tops. While this could signal that the froth and excesses are out of the market, it could also imply that we are only through the first stage of a protracted decline, with more pain to come as we find out how much of the growth in emerging markets was tied to the developed world. Indeed, after achieving a record 39% *average annualized return over the preceding five years*, investors may need to prepare themselves for much more modest gains; since 1988 emerging markets equities have generated an average five-year return of 12%, while over 1999–2002, the average annual return was only 1.5%.

Valuations Moving Closer to Fair Value

As a result of the carnage, valuations have improved substantially from last year's peak, although we do not agree with some commentators that emerging markets equities have reached trough-like levels. Indeed, much has been made of the fact that the trailing 12-month price-earnings (P/E) ratio for the MSCI Emerging Markets Index has fallen from 18.5 in October 2007 to below 13 in August (Table F), a level last seen in 2005, while P/E ratios based on forward estimates are now in the single digits for several countries and 9 for the index as a whole—a level last seen at the end of the Asian financial crisis in 1998. However, we would note that such seemingly cheap valuations still reflect that the fact that earnings and return on equity (ROE) are at peak levels, and that forward earnings expectations are quite optimistic, penciling in 18% growth for emerging markets as whole in 2009, a year in which the global economy may stall.

Our normalized valuation measures (which try to adjust for the profit cycle) show emerging markets equities not as cheap, but closer to the fair-value range. Our preferred measure, the ROE-adjusted P/E ratio, fell from 25 in October 2007 to 18 by the end of July, or from 2.7 standard deviations above a post-1994 average P/E of 15 to only 0.8 standard deviation above. In 2001 this measure fell to 10 times earnings, while in 1998 it bottomed below 8. In other words, at a normalized P/E of 18, emerging markets equities are far from depressed levels.

Furthermore, behind the P/E of the index lies a notable divergence in regional valuations, as the run up in commodity-related stocks has left Latin America looking quite pricey on an ROE-adjusted basis at 21 (compared to a historical average of 14), while Asia, which has borne the brunt of the selling, looks much more reasonably priced at 17, only slightly above its historical average. The Eastern European and Middle Eastern/African markets also seem reasonably valued (Table G). Relative to developed markets, emerging markets again trade at a discount based on trailing P/E ratios, although they remain close to parity based on relative ROE-adjusted P/E and price-to-book ratios (Table H). This implies that investors haven't yet completely downgraded emerging markets equities, although Asia is trading at a discount to both the MSCI Emerging Markets and World indices.

Importantly, the entire decline in the emerging markets equities index has been the result of multiple contraction, not falling earnings, implying that investors have priced in some level of future earnings disappointment. Whether or not this cushion proves sufficient should global growth grind to a halt and emerging markets profits tumble remains to be seen. However, it should be clear that emerging markets equities are no longer priced for perfection.

Over the long run we agree with the notion that emerging markets equities may deserve a premium over developed markets equities given their stronger earnings growth prospects. However, in the short term, emerging markets equities may derate further, especially if investors continue to pull back from the region, while the outsized weighting to commodities and cyclical sectors argues that more of an emerging markets discount may be in order. Meanwhile, investors can take some comfort in the fact that unlike 1994 or 1997–98, emerging markets economies are not on the verge of collapse brought about by excess consumption and reliance on short-term foreign debt (with Eastern Europe a major exception[3]). Nevertheless, in addition to the principal risk of earnings contraction in a slowing global economy, emerging markets may face some additional headwinds.

First among these is a stronger US$. Dollar strength has traditionally been negative for emerging markets equities, at least in relative performance terms, despite the improved terms of trade this should imply. This is because US$ rallies often signal rising risk aversion, with investors pulling out of smaller, higher risk markets. To the extent that a rising dollar and falling commodity prices are related, this will also pressure emerging markets equities. While our secular view remains that the US$ will weaken further against emerging markets currencies, we have expected a US$ counter-trend rally to occur at some point this year given the dollar's oversold conditions and weakening growth expectations elsewhere.[4] Should the recent dollar rally continue, this will remain a short-term headwind for emerging markets.

Paradoxically, emerging markets may also suffer if growth does *not* slow. Most of these economies are already showing clear signs of overheating, with high headline and core inflation brought about by rising commodity prices and unit labor costs. Rising wages and input costs are threatening profit margins, while food inflation (which has a larger impact on real wages in the emerging markets world as food accounts for a

[3] While the economies of Eastern Europe have weathered the storm thus far, macro fundamentals are less strong in this region than elsewhere in the emerging markets world. Please see our February 2007 Market Commentary *All Quiet on the Eastern Front?*
[4] Please see our October 2007 Market Commentary *Does the "Buck" Stop Here?*

much larger share of consumption) is sparking social unrest, especially where governments are balking at the rising cost of food and energy subsidies.

Obviously, the risk we run in advising caution toward emerging markets equities is that global growth slows but does not grind to a halt, while inflation moderates and central banks begin easing policy rates. Under such circumstances we would expect to see stock markets rally and global investors rush back into emerging markets equities.

Meanwhile, how much more pain could investors suffer? If the Chinese economy were to crash and burn, all bets would be off. However, since emerging markets economies are better positioned than in the past to handle any slowdown in the developed world, we would be surprised to see normalized valuations return to the levels seen in 1998 or even 2001. If we assume emerging markets valuations simply revert to their long-term normalized mean of 15, then another 15% decline may clear the market. In the event that emerging markets equities fall (after the massive run-up in 2007) from overvalued to undervalued, a further decline of 30% could be in the cards, resulting in a peak to trough decline of nearly 50%. While this sounds dramatic, a similar loss was seen in the 2000–02 bear market (Table I) and valuations were at a much higher starting point in 2007.

In a sense, this fits in with our broader view of this global bear market. The losses in global equities seen over late 2007 and mid-2008 constituted the first leg, brought about by credit concerns in the United States and Europe and led by tumbling financial shares, with emerging markets equities the victims of collateral damage from highly integrated capital markets. This partly explains emerging markets equities' resilience early on—emerging markets were not the source of the financial trouble and benefited from heavy commodity exposure. Now the second half of the bear market starts, where the impact of tight credit markets creates a global recession with earnings losses spreading from financials to all sectors. In this scenario, emerging markets equities remain highly leveraged to the global economic cycle, and therefore may see outsized losses. However, when the cycle turns up, or proves less virulent than we fear, emerging markets are likely to lead any rally at the expense of developed markets. In other words, emerging markets equities still have a beta greater than 1.

Conclusion

Emerging markets equity valuations are not very compelling, but most of the froth seen in the run-up over 2007 has been taken out. While we expect further weakness in emerging markets equities as the global economic outlook deteriorates, this could set the stage for aggressive policy easing and spark a sharp equity rally, likely at some point in 2009. Timing, however, is always uncertain, and the risk of a prolonged slump remains. Investors that are substantially underweight emerging markets equities may want to begin rebuilding exposure on further weakness, as rebalancing remains the key to successfully navigating any bear market. But at this juncture, we would still advise against aggressively overweighting. Over the long run, the superior growth outlook for emerging markets economies will again be priced into the shares; however, in the short run, growth concerns will dominate. As we said last fall, while emerging markets economies may be able to decouple in an *economic* sense, financial markets clearly have not.

APPENDIX

Domestic Demand in Emerging Economies: A Shift Toward Small Caps?

What the emerging world needs right now is a period of cooling to fight off growing inflationary pressures. A prolonged period of sluggish demand from the U.S. economy may perhaps mark a shift toward more internally focused policies oriented toward promoting domestic demand—a shift the Chinese authorities, for example, are clearly targeting. Thus, the next leg of the emerging markets bull market may be led by companies feeding this rising domestic demand, rather than by the more traditional emerging markets champions in the industrial and commodity sectors.

Given the current lopsided nature of the MSCI Emerging Markets Index, an opportunity exists for active managers to take broad positions against the benchmark, geared toward the long-term story of rising living standards and a growing middle class.[5] Increasingly, it seems that smaller-capitalization companies provide such an opportunity.

As the recently released MSCI Emerging Markets Small Cap Index indicates, these smaller-capitalization companies provide investors with limited exposure to energy (at 2%) and increased exposure to the sectors and industries more geared to domestic demand (Table J). This limited exposure to energy also tilts the small-cap universe toward Asia (66% of the Emerging Markets Small Cap Index as opposed to less than 50% for the MSCI Emerging Markets Index), which also fits into our strategic advice to overweight Asia over the long term.

And in contrast to the United States and Europe, emerging markets small caps currently do not trade at a premium to large caps, and have largely underperformed during the emerging markets bull market thus far. Should investors begin thinking about dedicated emerging markets or Asian small-cap managers? At this point in the cycle of broad macro deterioration and ebbing liquidity, it may be too soon to tilt heavily toward small caps, which are intrinsically more vulnerable to deteriorating economic conditions. Furthermore, most active managers may already have a small-cap bias relative to the benchmark, and are likely to increase this bias as the cycle progresses, especially if commodity-related stocks continue to sink. In other words, it may be too soon for dedicated emerging markets small-cap allocations, but a value-driven active manager might already be digging in this space anyway.

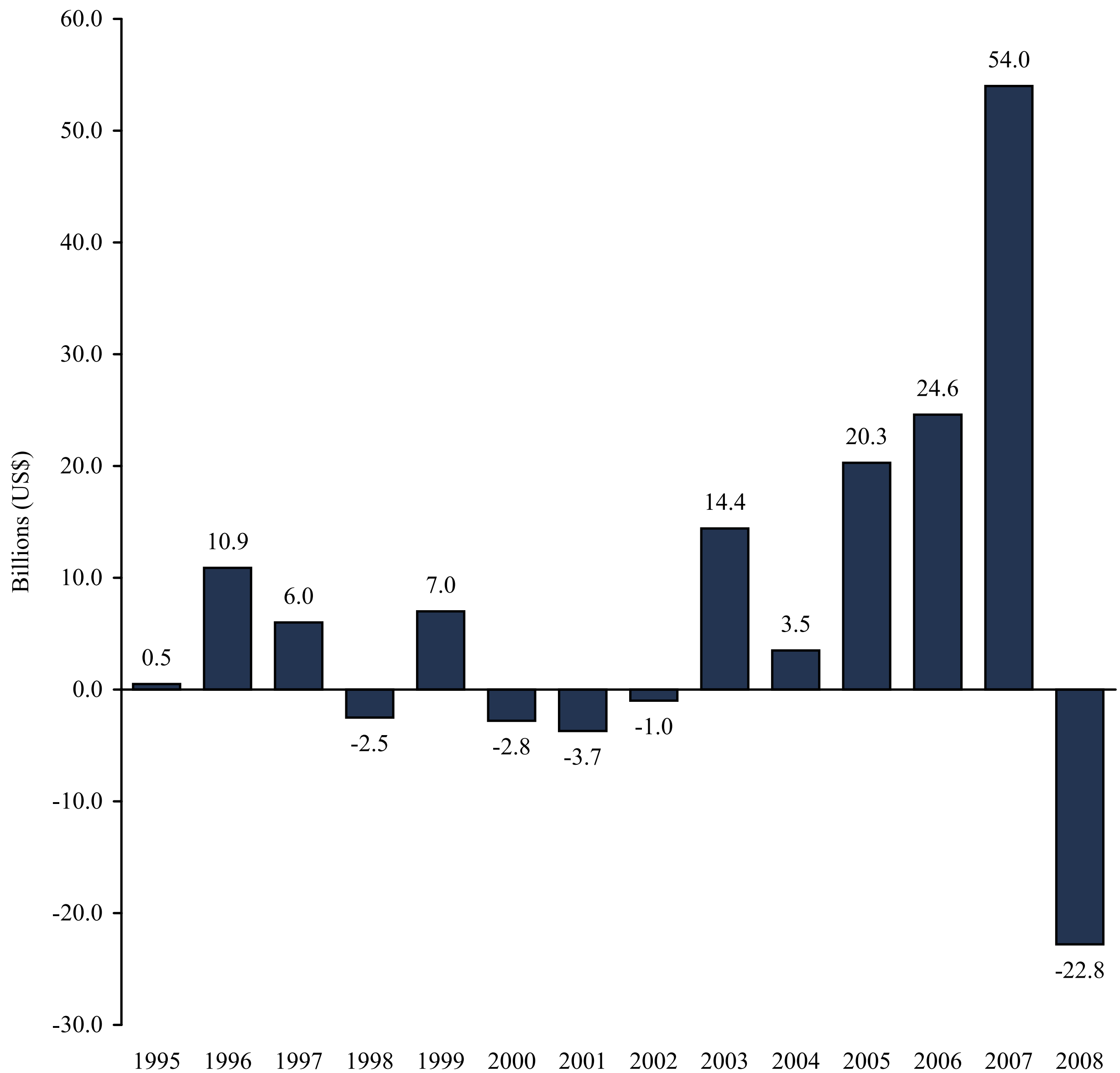
[5] Energy and materials sectors account for over 40% of the index, whereas consumer discretionary, consumer staples, and health care account for only 12%.

Table A

NET INFLOWS INTO EMERGING MARKETS FUNDS

1995–2008

All Dedicated Emerging Markets Equity Funds



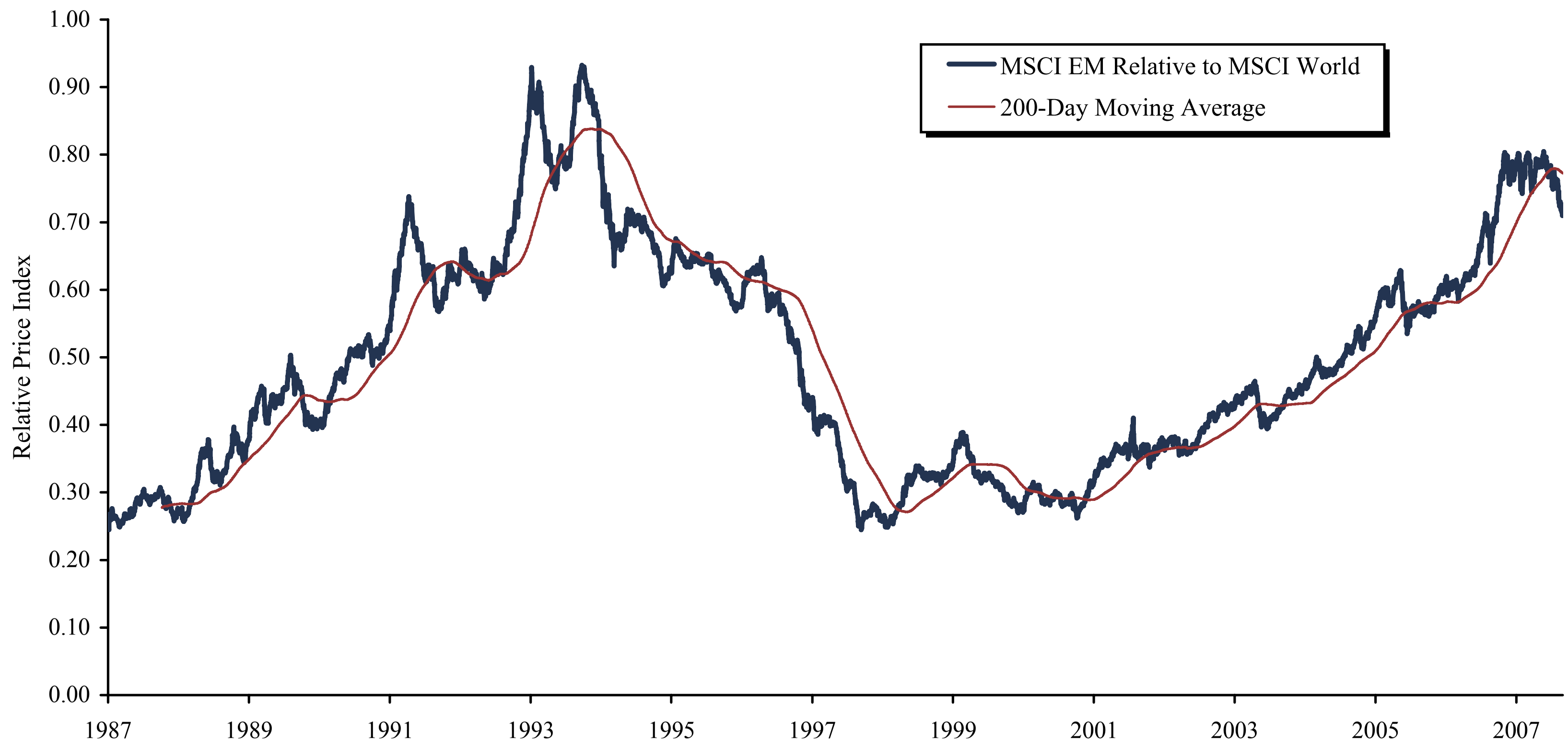
Sources: EPFR Global and Morgan Stanley Research.

Note: Data for 2008 are through August 14.

Table B

MSCI EMERGING MARKETS INDEX RELATIVE TO MSCI WORLD INDEX

December 31, 1987 – August 27, 2008



Sources: MSCI Inc. and Thomson Datastream.

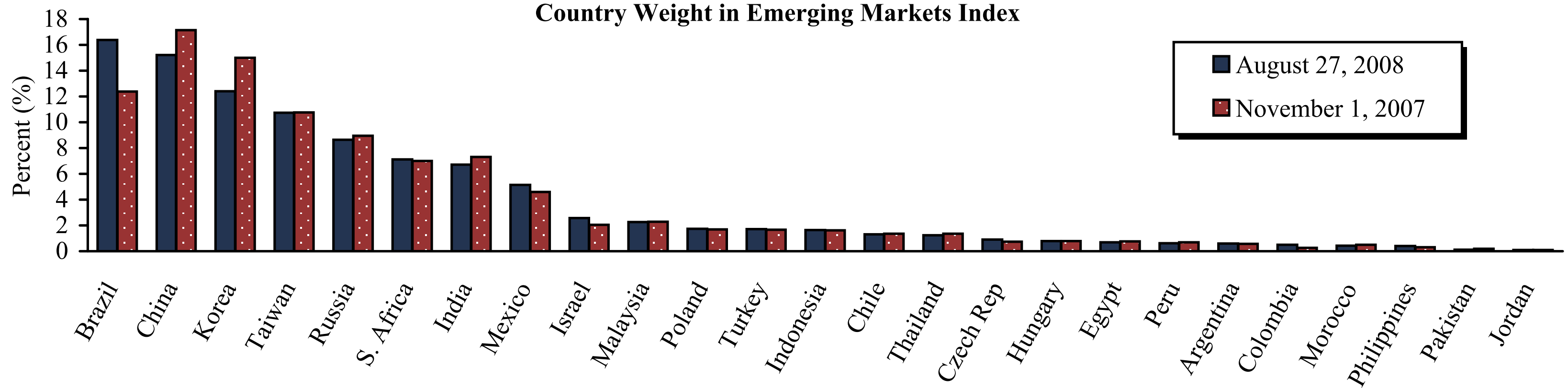
Note: Graph is based on price index levels in US$ terms using daily data.

Table C

MSCI EMERGING MARKETS COUNTRY INDICES

Price Decline from Recent Peak (Local Currency Terms) – August 27, 2008

Country Weight in Emerging Markets Index



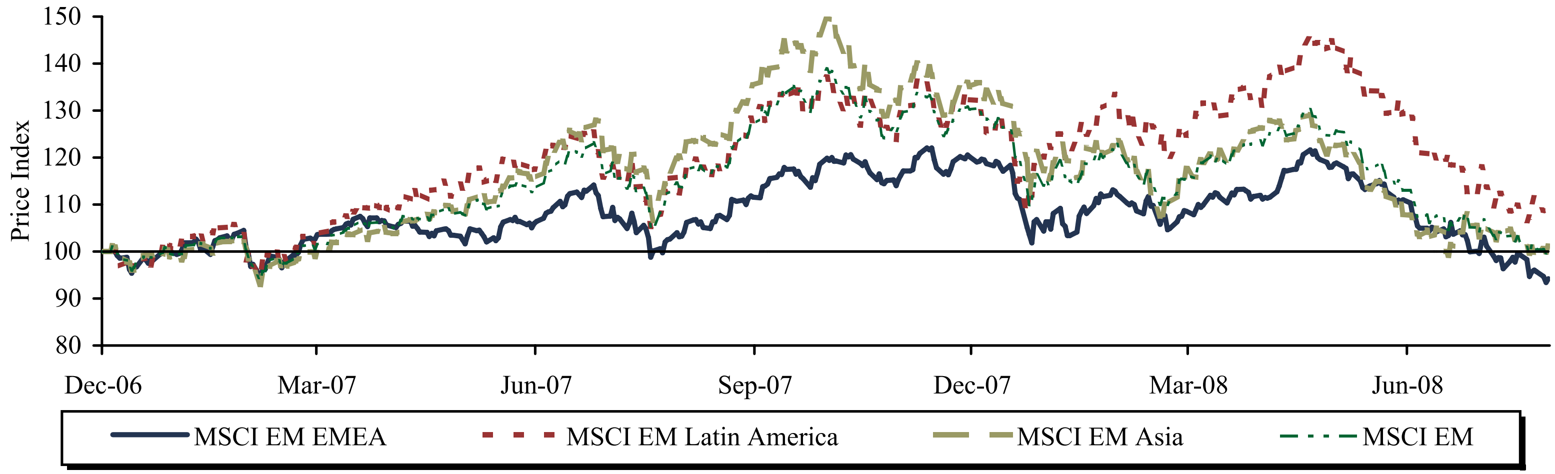
Sources: FactSet Research Systems, MSCI Inc., and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Notes: Country weight based on market capitalization. Time frame for recent peak ranges from January 1, 2007, to August 27, 2008.

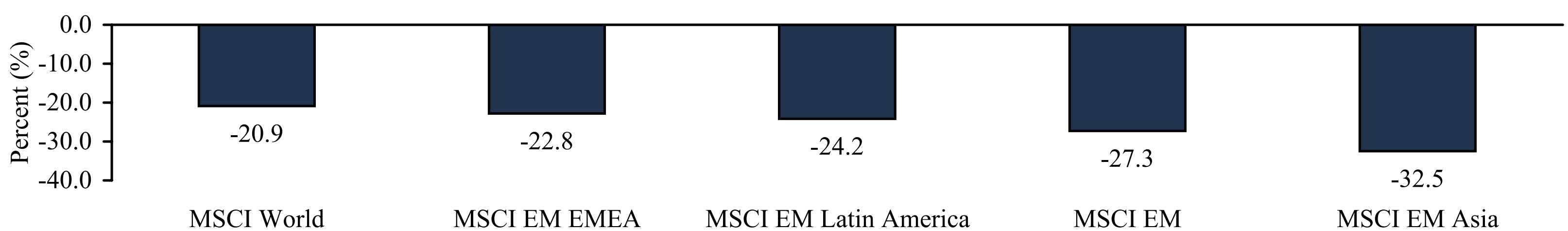
Table D

MSCI EMERGING MARKETS REGIONAL INDICES

January 1, 2007 – August 27, 2008



Decline from Recent Individual Peak to August 27, 2008



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

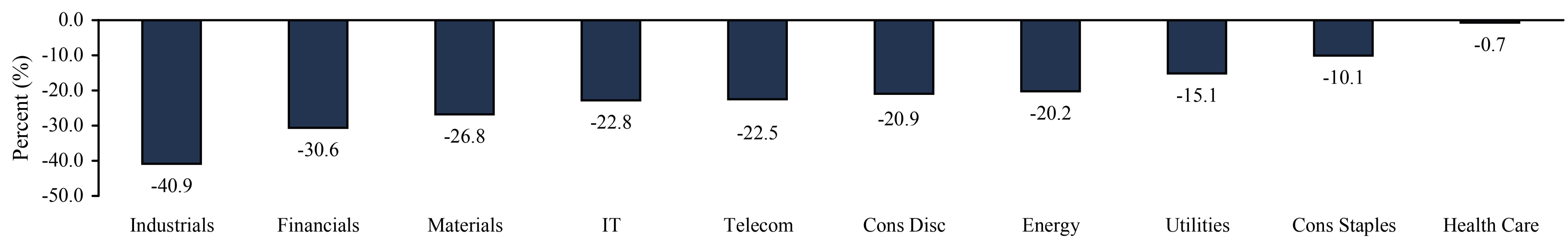
Notes: Based on local currency daily data. Price index levels rebased to 100. Time frame for recent peak ranges from January 1, 2007, to August 27, 2008. MSCI EMEA region consists of the Czech Republic, Egypt, Hungary, Israel, Jordan, Morocco, Poland, Russia, South Africa, and Turkey.

Table E

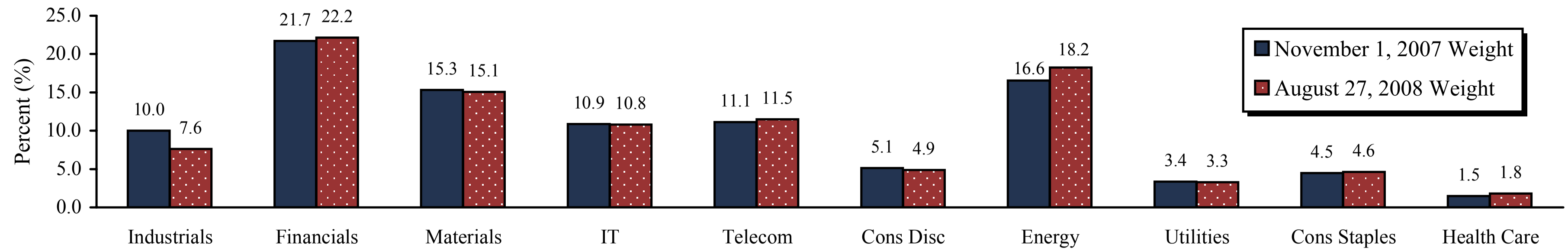
PERFORMANCE ATTRIBUTION FOR MSCI EMERGING MARKETS INDEX SECTORS

November 1, 2007 – August 27, 2008

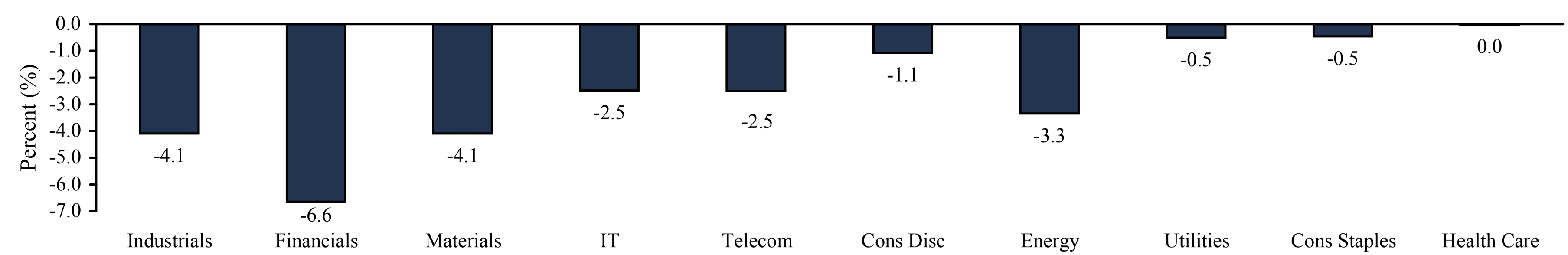
Cumulative Performance



Sector Weights



Contribution (Percentage Point Added to Index)



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

Notes: Contribution represents the sector's percentage point addition to the EM Index return of -25.4. Sector contributions are calculated by multiplying the sector's November 1, 2007, weight by its cumulative local currency return from November 1, 2007, to August 27, 2008. Percentages may not total due to rounding.

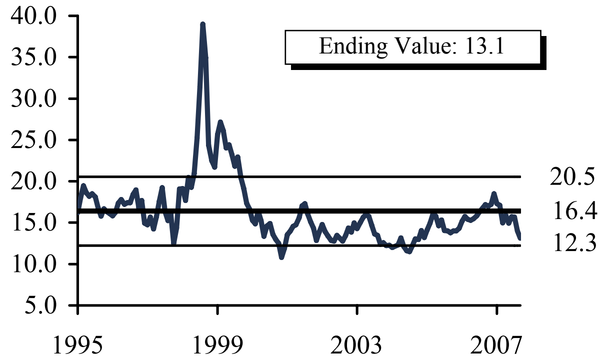
Table F

GLOBAL EQUITY MARKET VALUATIONS

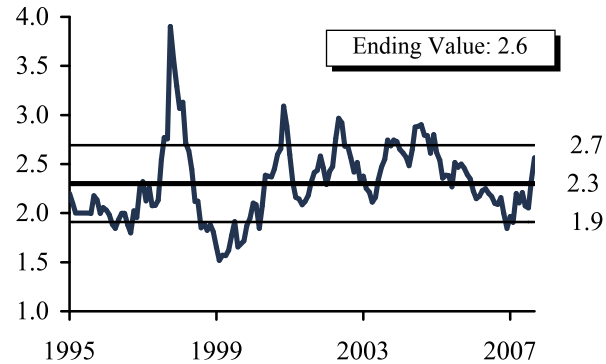
MSCI Emerging Markets Index

November 30, 1995 – July 31, 2008

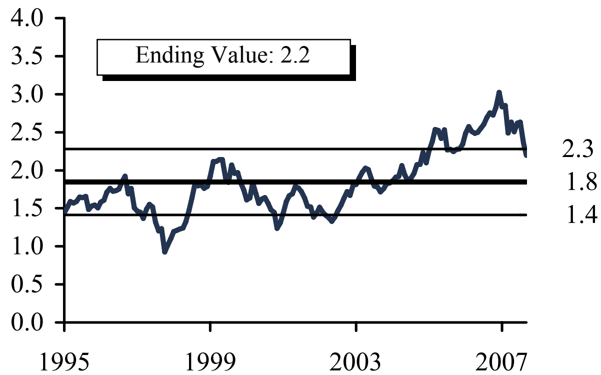
Price-Earnings



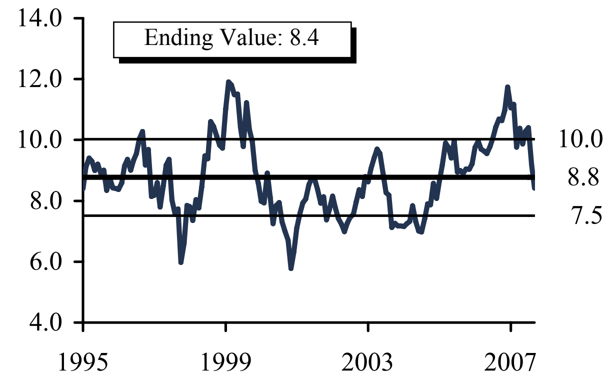
Dividend Yield (%)



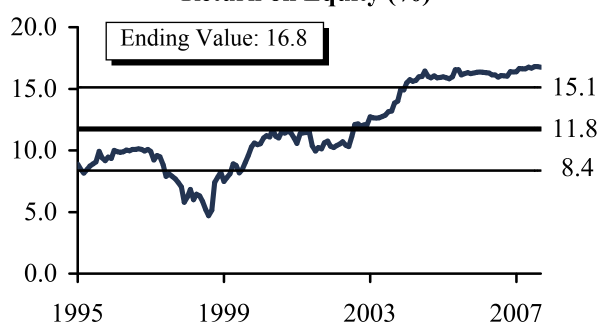
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)



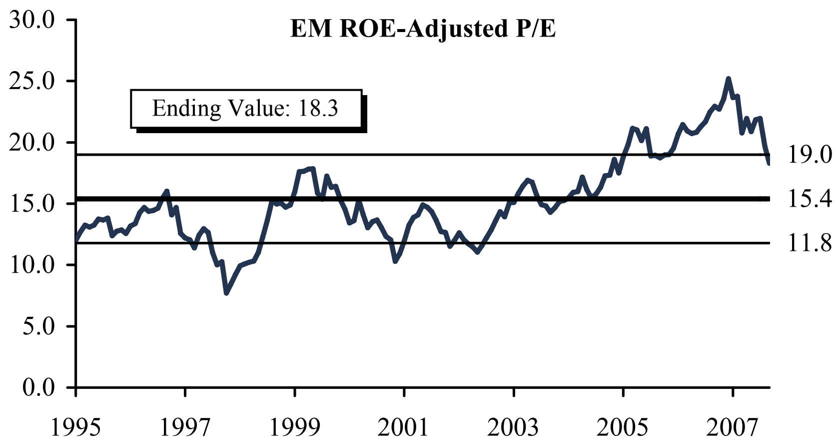
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

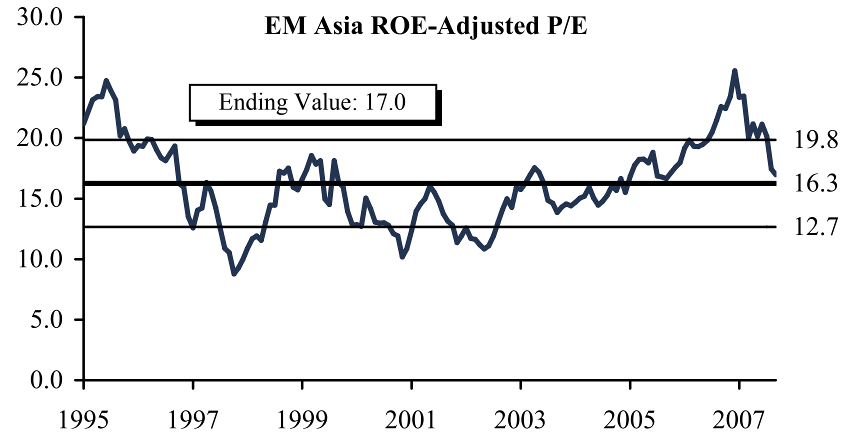
Note: Return on equity is calculated by dividing the index's price-to-book value ratio by its price-earnings ratio.

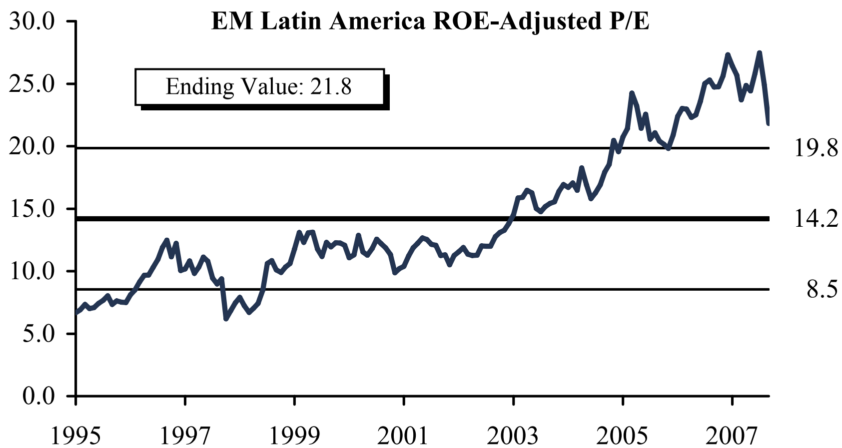
Table G

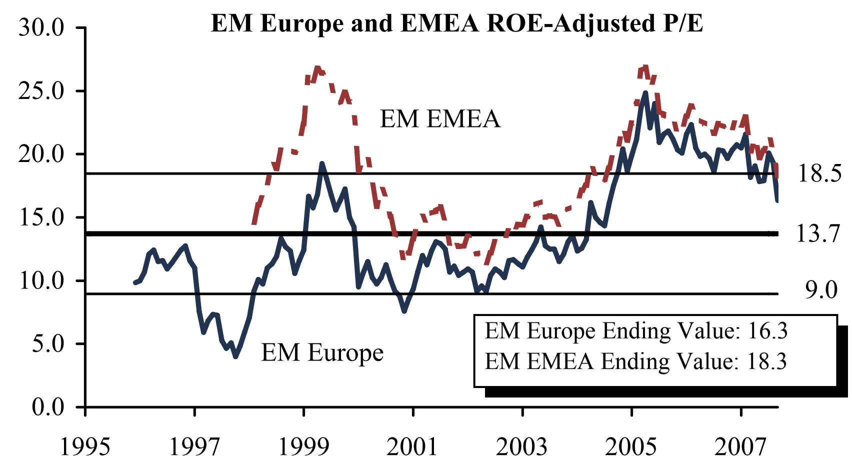
MSCI EMERGING MARKETS REGIONAL PRICE-EARNINGS VALUATIONS

November 30, 1995 – July 31, 2008









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

Notes: Return on equity (ROE) is calculated by dividing the index's price-to-book ratio by its price-earnings (P/E) ratio. The ROE-adjusted P/E ratio is the current trailing P/E ratio multiplied by the ratio of the current level of ROE to an assumed long-term historical average ROE of 12 for equity markets. Mean and standard deviation values on EM Europe/EE EMEA refer to EM Europe.

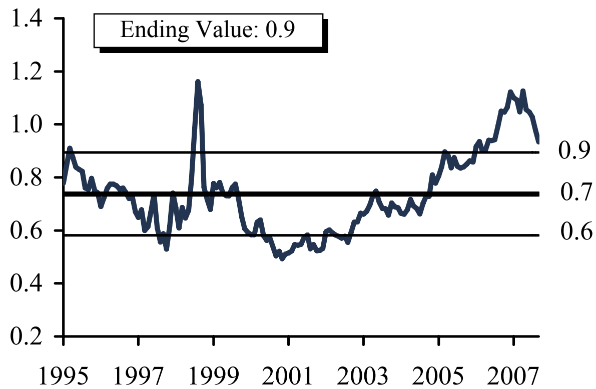
Table H

GLOBAL EQUITY MARKET VALUATIONS

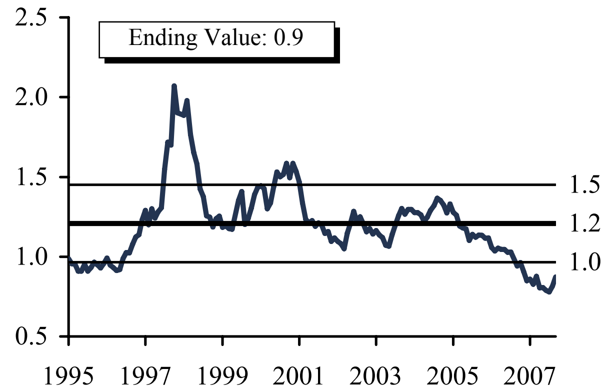
MSCI Emerging Markets Relative to MSCI World Index

November 30, 1995 – July 31, 2008

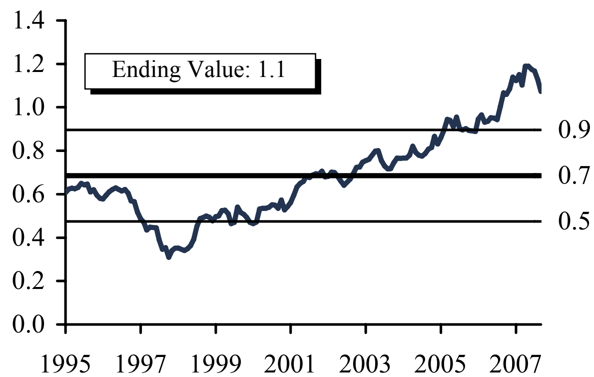
Price-Earnings



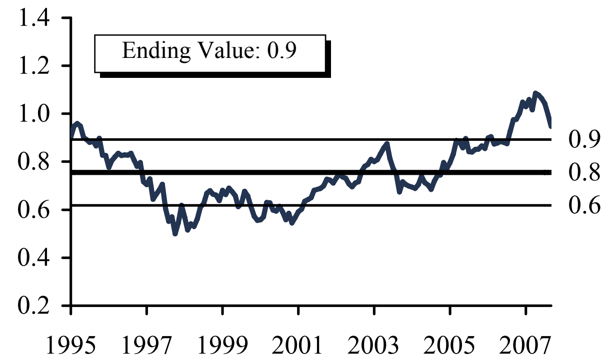
Dividend Yield (%)



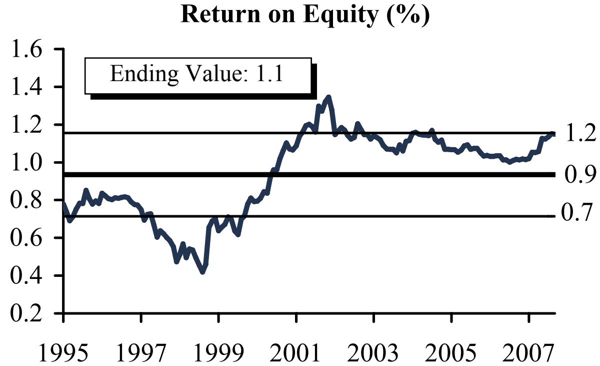
Price-to-Book Value



Price-to-Cash Earnings



Return on Equity (%)

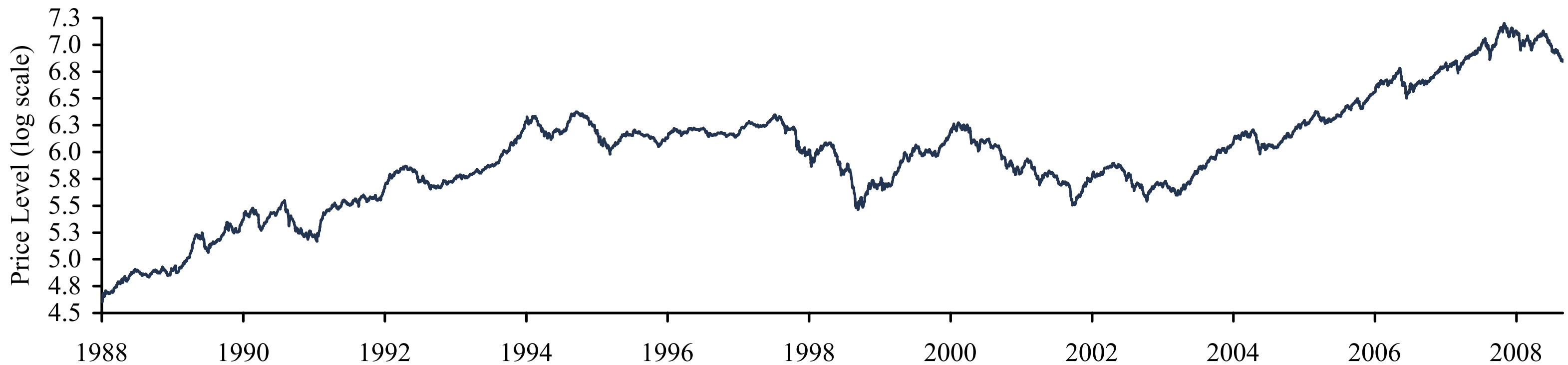


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Table I

MSCI EMERGING MARKETS EQUITIES PEAK TO TROUGH DECLINES

January 1, 1988 – August 27, 2008



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	28.0 *
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
Current Bear Market					
October 29, 2007	August 26, 2008**	-29.9	9.9	--	--

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

Notes: Data based on MSCI EM Index price levels in US$ terms. The graph is displayed in logarithmic scale. Bear markets are defined as a price decline of at least 19%. Analysis based on daily data from January 1, 1988, to August 27, 2008.

* The MSCI 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.

** August 26, 2008, is the current low for the index in US$ terms and not necessarily the final low.

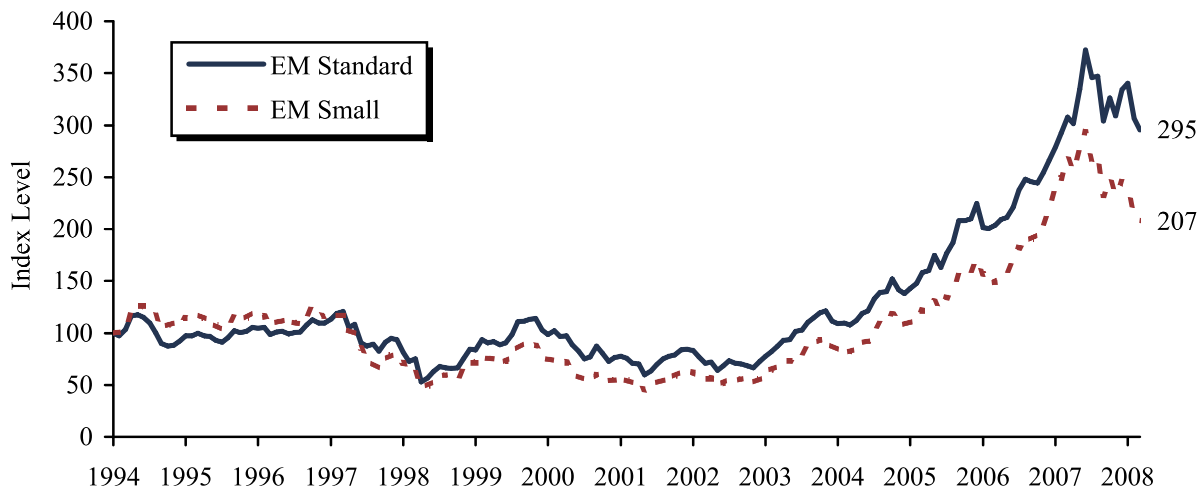
Table J

MSCI EMERGING MARKETS SMALL CAP INDEX RELATIVE TO MSCI EMERGING MARKETS

As of July 31, 2008

	EM Small	EM Standard	Small-Cap Relative Weighting
Number of Companies	1,656	787	
Market Capitalization (US$ billions)	405.4	3,208.3	
Sector Weights (%)			
Energy	1.9	18.7	-16.8
Materials	14.5	15.9	-1.4
Industrials	16.7	7.9	8.8
Consumer Discretionary	15.9	4.8	11.0
Consumer Staples	8.5	4.5	4.0
Health Care	4.9	1.6	3.2
Financials	19.0	21.9	-2.9
Information Technology	13.7	10.0	3.7
Telecommunication Services	1.5	11.3	-9.9
Utilities	3.4	3.2	0.2
Region Weights (%)			
Africa/Middle East	15.8	12.5	3.3
Asia/Pacific ex Japan	66.0	49.9	16.1
Europe	4.0	13.3	-9.3
Latin America	14.2	24.3	-10.2

Total Return in U.S. Dollars
(Rebased to 100 at May 31, 1994)



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