CAMBRIDGE ASSOCIATES LLC

GLOBAL MARKET COMMENTARY

EMERGING MARKETS EQUITIES HAVE BECOME OVERVALUED

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Emerging Markets Equities Have Become Overvalued

Last June, we opined that emerging markets equities were fairly valued, although near the top end of that range.[1] Since that time, the MSCI Emerging Markets Index has returned 23.9% (in local currency; returns were 26.2% in US$), pushing most of the metrics we track into overvalued territory. Specifically, with the exception of price-earnings (P/Es) based on trailing 12-month earnings, every P/E measure we look at is now more than 1 standard deviation above its long-term average (Table A). While emerging markets equities remain attractive relative to those of developed markets, we are moving the asset class from fairly valued to overvalued. We should stress that this in no way alters our long-term positive view of the asset class—based primarily on secular improvements in many economies and strong prospects for economic and corporate profit growth—but instead reflects our opinion that prices have become excessive relative to current fundamentals. Further, given that the recent period of low volatility has likely been an aberration rather than a secular shift, we expect emerging markets to be hit hard when (not if) global markets eventually hit a rough patch.

Multiple Issues

Given the paucity of reasonably valued asset classes currently available, we do not relish the idea of moving emerging markets equities to the overvalued camp. Nevertheless, the recent run-up in prices has pushed most valuation metrics beyond what we consider "fair value." The metric we find most useful for valuing emerging markets equities, the return on equity (ROE)-adjusted P/E ratio,[2] now shows multiples to be a full standard deviation above their long-term average. Further, the P/E according to this measure is 22.4—significantly higher than the "standard" P/E (using trailing 12-month earnings) of 17.4. As noted in our piece last June, the normalized ROE measure smoothes out cyclical fluctuations (such as the short-term plunge in ROE in the aftermath of the 1997-98 crisis), and also shows the gradually rising trend of emerging markets ROE over the past few years. Thus, readings likely represent a better proxy for *sustainable* earnings—the level important to investors—than other measures.

Other metrics also show emerging markets equities to be overvalued, with P/E ratios based on normalized real earnings, normalized nominal earnings, and a static ROE of 11%[3] all more than 1 standard deviation above their long-term means. Indeed, as with developed markets, the only P/E metric that looks reasonable for emerging markets is the standard measure based on trailing 12-month earnings, which has of course benefited from the recent surge in earnings.

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[1] Please see our June 2006 Global Market Commentary: *A Closer Look at Emerging Markets Equity Valuations.*
[2] The ROE-adjusted P/E ratio is the 12-month trailing P/E ratio normalized for the differential between current and historical ROEs by multiplying the P/E by the ratio of the current ROE to its historical average. In this instance, we use a five-year average.
[3] In other words, we assume a constant ROE of 11%, which is roughly halfway between the historical average of 10.2% for the IFCI and our assumed level of 12% for developed markets.

Of Relative Interest

Still, as noted above, we continue to view emerging markets equities as attractive relative to those of developed markets. This is due in part to the fact that emerging markets still trade at a discount to developed equities (albeit much slimmer than in the recent past), and also to better prospects for economic and corporate profit growth. Indeed, while a good deal of recent growth in the developed world appears due to cyclical factors (particularly in the United States, where growth has been funded to a large degree by increasing debt), many emerging markets seem to be getting stronger by the day, with ballooning current account surpluses and declining inflation rates, and growth that increasingly flows to the bottom line of corporations. In short, while *developed* markets earnings are likely to revert to their long-term historical mean at some point, the same is not necessarily true for emerging markets profits, given that at least some of their recent growth has been tied to secular improvements—such as improved capital allocation and much-improved discipline on the part of governments, many of which boast rapidly growing foreign exchange reserves—that have altered the underlying fundamentals. The growth in FX reserves, for example, both in absolute terms and as a percentage of GDP, has to a large degree insulated emerging markets from a replay of the contagion-type crises that have historically swept the asset class and decimated corporate profits. Therefore, barring a global recession emerging markets profits should continue to grow at a rapid pace.

Indeed, despite our more cautious stance on emerging markets equities, we do not view the major risk to the asset class as a decline in fundamentals. Instead, in our view the biggest risk to emerging markets is a global retreat from risk, much as we saw in May 2006 to June 2006, and to a smaller degree in late February 2007 to early March 2007. Despite recent economic improvements, emerging markets equities remain high-risk assets, and thus likely to suffer disproportionately when risk aversion returns to global markets. Further, while flows into emerging markets equity funds have slowed markedly since their frenetic pace of a year ago, there is undeniably a good deal of "hot money" in the sector likely to head for the exits at the first sign of trouble. Consider that in May 2006 to June 2006, emerging markets equities dropped by roughly 25% in the space of three weeks, despite the fact that *there was no change in fundamentals*. In other words, the asset class lost about a quarter of its value based not on some fundamental shift, but simply due to investors re-evaluating their tolerance for risk.

Regional Concerns

While investors generally leave decisions about relative regional and country weights to their managers, there are currently a few issues of differentiation that bear mentioning.

From a valuations standpoint, there is little to distinguish emerging markets regions at present, with trailing 12-month P/E ratios ranging from 13.8 (emerging Europe and the Middle East) to 16.3 (Asia). However, there is a good deal of variation in macroeconomic conditions. For example, while emerging markets in aggregate show growing FX reserves and declining inflation rates, this is not true across the board. Indeed, looked at from a regional perspective, it is primarily Asian and oil-rich countries (e.g., Russia and those in the Middle East) that have significant and growing reserves, while Latin American countries

have a much smaller cushion on which to fall back, and Eastern Europe is running substantial deficits (Table B). (It should also be noted that regional data tend to present an oversimplified picture. To cite two prominent examples, India is currently running a current account deficit, while Brazil is running a surplus.) Inflation, meanwhile, is on the rise in countries such as Argentina, India, and Indonesia (Table C).

In short, while we and others tend to refer to emerging markets as a homogenous asset class, this is far from the case, as there are substantive differences among emerging countries and regions.

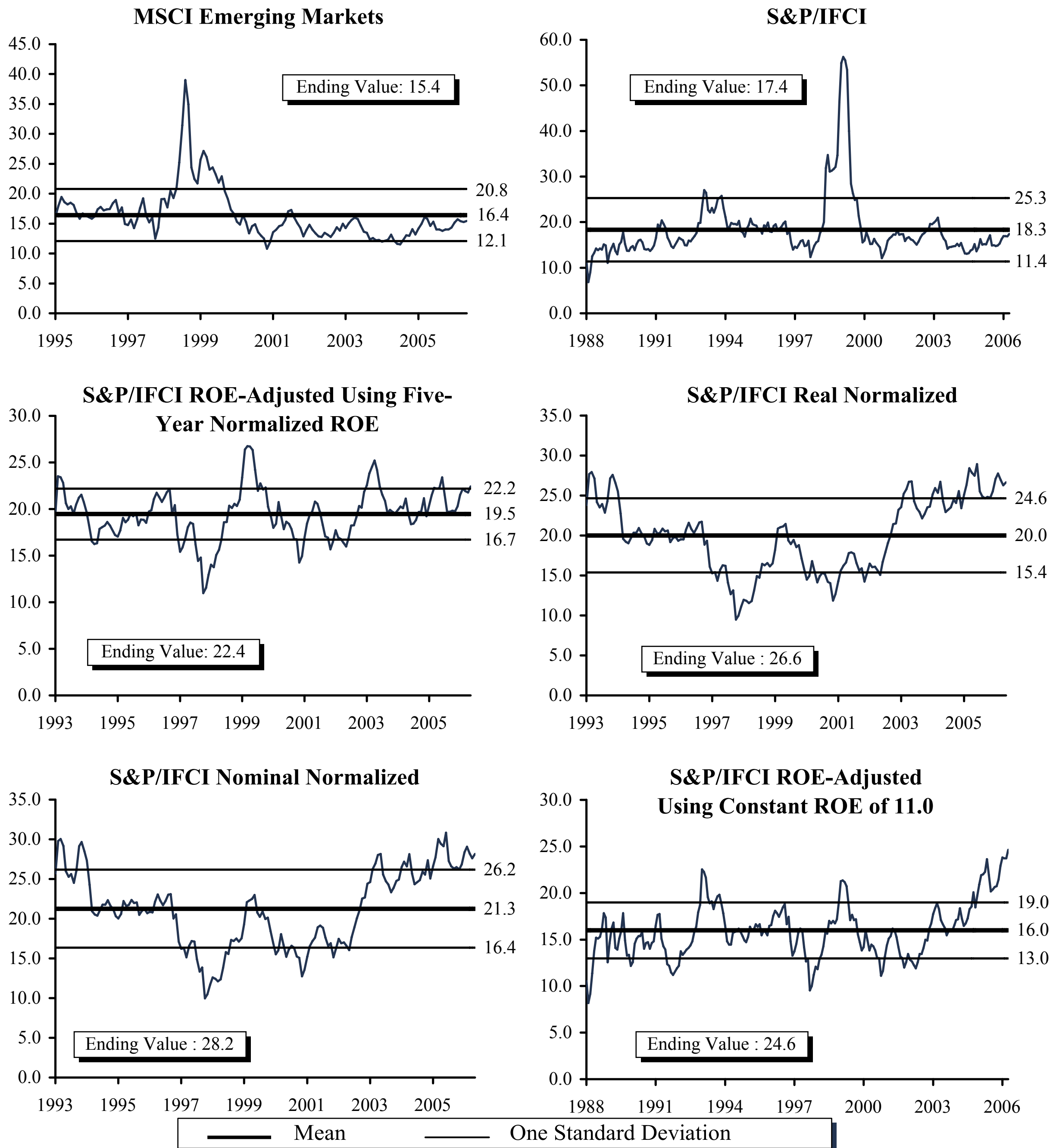
Conclusion

We continue to believe emerging markets equities are well positioned from a secular standpoint, and that investors should maintain policy targets above their market weight of roughly 7% of global equities. However, investors should assiduously rebalance to policy targets, as a tactical overweight entails material price risk in the current environment. For those looking to build positions, meanwhile, now may not be the optimal time to do so. While attempting to time these markets can be a fool's errand, valuations have reached the point where most of the good news is already discounted, although clearly we cannot rule out additional short-term gains. Further, given that emerging markets are likely to suffer harshly when risk aversion again rears its head, it is probable (although not, of course, guaranteed) that patient and disciplined investors will be rewarded with more attractive entry opportunities than currently exist.

Table A

VARIOUS EMERGING MARKETS PRICE-TO-EARNINGS RATIOS

December 31, 1988 - March 31, 2007



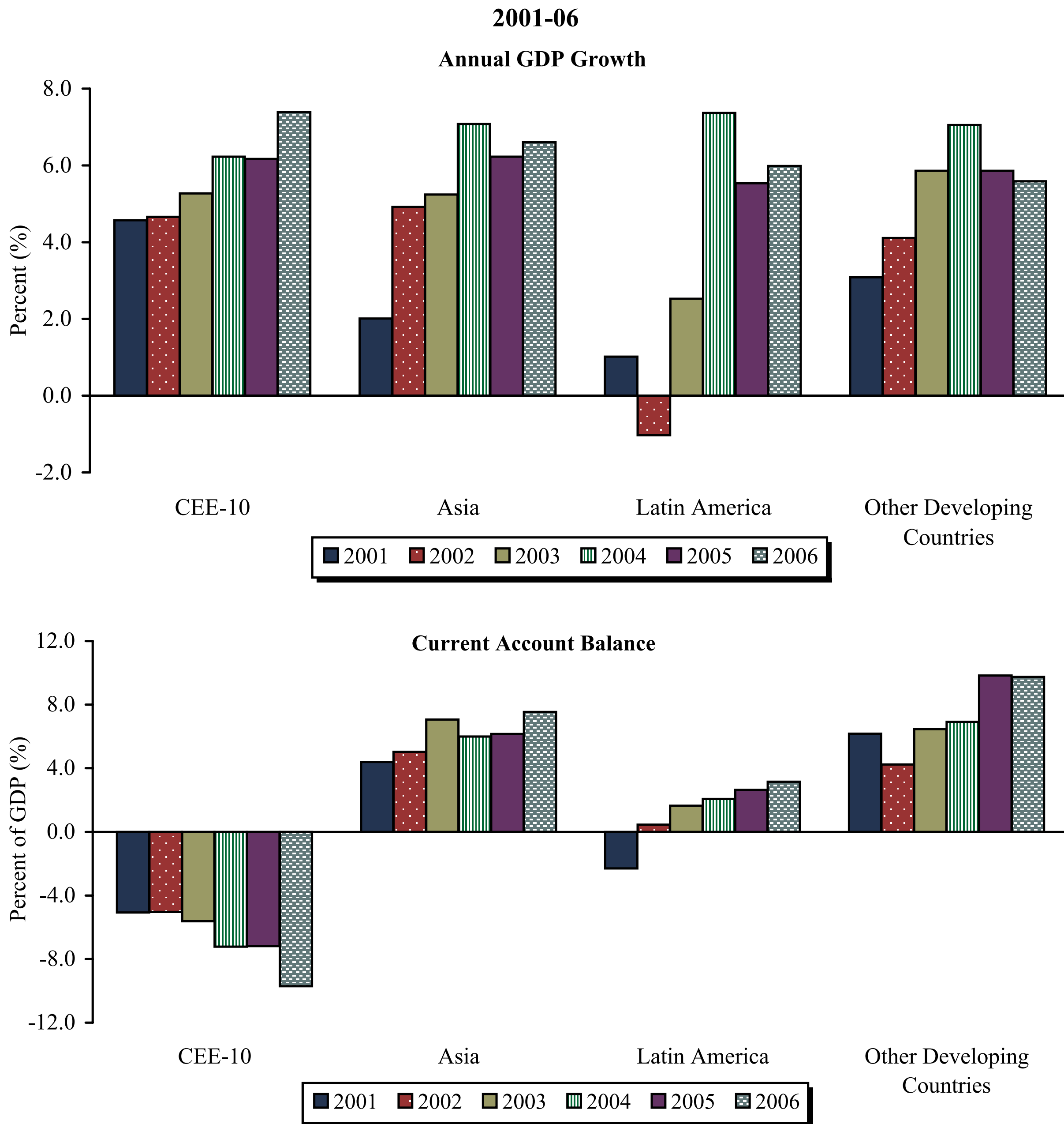
Sources: Calculated from data provided by Standard & Poor's, Morgan Stanley Capital International, and Thomson Datastream. MSCI data provided "as is" without any expressed or implied warranties.

Notes: The five-year normalized ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to the average ROE of the previous five-year period. Normalized real P/E ratios are calculated by dividing the current real price index value, in U.S. dollars, by the annualized average real earnings for the trailing five years. The index is deflated using the CPI-U. Nominal normalized P/E ratios are calculated by dividing the current nominal price index value, in U.S. dollars, by the annualized average nominal earnings for the trailing five years. The constant ROE-adjusted P/E ratio is the current P/E based on trailing 12-month earnings multiplied by the ratio of the current ROE to a constant level of 11.0. ROE is calculated by dividing the index's P/B ratio by its P/E ratio.

Table B

EMERGING MARKETS GDP GROWTH AND CURRENT ACCOUNT BALANCES

2001-06



Sources: International Monetary Fund and World Economic Outlook Database.

Notes: Regional figures based on an unweighted average of country data. CEE-10 is made up of Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia. Asia is made up of Hong Kong, Korea, Singapore, Taiwan, China, India, Indonesia, Malaysia, the Philippines, and Thailand. Latin America is made up of Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela. Other developing countries is made up of the Middle East, South Africa, Russia, and Turkey.

Table C

MACROECONOMIC INDICATORS FOR MSCI EMERGING MARKETS COUNTRIES

As of December 31, 2006

Country	Real GDP Growth (%)	Inflation (%)	Current Account Balance as a % of GDP
Argentina	8.5	10.9	2.4
Brazil	3.7	4.2	1.3
Chile	4.0	3.4	3.8
China	10.7	1.5	9.1
Colombia	6.8	4.3	-2.2
Czech Republic	6.1	2.5	-4.2
Egypt	6.8	4.2	0.8
Hungary	3.9	3.9	-6.9
India	9.2	6.1	-2.2
Indonesia	5.5	13.1	2.7
Israel	5.1	2.1	5.2
Jordan	6.0	6.3	-16.0
Korea	5.0	2.2	0.7
Malaysia	5.9	3.6	15.8
Mexico	4.8	3.6	-0.2
Morocco	7.3	3.3	3.9
Pakistan	6.2	7.9	-3.9
Peru	8.0	2.0	2.6
Philippines	5.4	6.2	2.9
Poland	5.8	1.0	-2.1
Russia	6.7	9.7	9.8
South Africa	5.0	4.7	-6.4
Taiwan	4.6	0.6	7.1
Thailand	5.0	4.6	1.6
Turkey	5.5	9.6	-8.0

Sources: International Monetary Fund, Morgan Stanley Capital International, and World Economic Outlook Database. MSCI data provided "as is" without any expressed or implied warranties.

Notes: Real GDP data for Argentina, Colombia, Hungary, India, Jordan, Morocco, Pakistan, Peru, and Turkey are estimates. Inflation data for Chile and Hungary are estimates. Current account balance data for Argentina, Chile, China, Colombia, Hungary, India, Indonesia, Israel, Jordan, Malaysia, Mexico, Morocco, Pakistan, Peru, the Philippines, and Turkey are estimates.