CAMBRIDGE ASSOCIATES LLC

EMERGING MARKETS COMMENTARY

Emerging Markets Equities: Still Cautious

May 2010

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Stretched valuations and macroeconomic uncertainty leave emerging markets equities vulnerable.

Introductory Note: This report was prepared in late April as global markets were reaching new highs for the year. Despite the wide swings in equity prices both on the downside and upside in early May, we thought it prudent to publish the paper "as is" given that the market is still in flux. While the numbers have changed, our key conclusions have not; we remain cautious on emerging markets equities in the midst of ongoing economic uncertainty and elevated valuations relative to other markets.

After surging over 70% from March to December 2009, the rally in emerging markets (EM) equities has begun to stall. The MSCI Emerging Markets Index returned 1.4% for first quarter 2010, lagging the MSCI World Index by 3.3 percentage points, the first quarterly bout of underperformance for EM equities since late 2008. While it is not surprising that high-beta EM equities were hit harder during the mid-January/early February global sell-off (with developed and EM equities declining 8% and 10%, respectively), what is more interesting is that EM equities have not led the advance from the recent market lows (Exhibit 1).

We have been tactically neutral on EM equities since last summer, when we felt that the large relative valuation premium sported by EM equities and the explosive run-up in the asset class had diminished the case for our recommended tactical overweight.[1] Indeed, EM relative performance has been flat since the middle of last year, with both the MSCI World Index and the MSCI Emerging Markets Index producing a 25% cumulative local currency return from June 2009 to March 2010.

Looking forward, we remain tactically neutral on EM equities. We feel the headwinds of valuation and global monetary tightening will continue to weigh on the asset class. In addition, EM equities remain vulnerable to any slowdown in global growth, especially fears related to Chinese growth.[2] Yet we still view the secular outlook as supportive of EM equities relative to developed markets, and we believe that investors should continue to build exposure to EM equities on bouts of market weakness. Future global growth will increasingly be driven by the emerging economies, which do not face the same debt burdens as the developed world. This near-term cautious, but long-term bullish, view raises admittedly difficult questions of timing and implementation for investors. Below we review our outlook for EM equities and the factors that inform our cautious stance as well as the risks to our views.

Shifting Gears?

Our caution toward EM equities stems from our overall macro view. Namely, we view the current environment as a difficult transition period for the global economy. The rebound in economic growth in 2009 was almost entirely driven by fiscal and monetary stimulus from both the developed and emerging worlds. The key issue confronting markets today is whether economic growth can successfully transition from stimulus-led growth to endogenous growth.

[1] Please see the Q&A on Quarterly Market Activity section of the June 30, 2009, edition of *Market Update*.

[2] Please see our 2010 Outlook Market Commentary *Asia ex Japan: Grab the Tiger by the Tail?*

Our base assumption is that most developed economies will not undergo a "normal" economic recovery driven by expanding credit and a re-leveraging of households and corporations. High unemployment and the need to reduce debt burdens will weigh on growth for some time. Meanwhile, the strong rebound in the emerging world has been aided by China's loan-fueled stimulus, which has powered EM exports and helped boost commodity prices. The risk remains that as stimulus measures are scaled back, perhaps forcibly due to sovereign debt concerns and/or economic overheating, the global economy will stall and slip back into low gear, dashing expectations.

At the same time, profits have surprised to the upside amid low interest rates and aggressive cost cutting by corporations, reducing fears of a "double dip" recession and helping drive global equities higher. Indeed, some pundits now anticipate that a "mini boom" will unfold as corporations, flush with cash, embark on a long-awaited capital expenditure cycle. At a minimum, the worst of the economic contraction has passed and recent economic data have generally been positive.

We are not dogmatic on the growth debate and do not think investors should position their portfolios heavily in favor of one outcome over the other (boom or bust), as we see the potential for both upside and downside risks to global growth this year and next. Instead, we continue to believe that markets will become increasingly choppy over 2010 as global policymakers attempt to withdraw economic stimulus, creating heightened uncertainty over the economic outlook.

For instance, the equity sell-off earlier this year triggered by heightened risk aversion resulting from fiscal stress in Europe, combined with a spate of disappointing economic data in the developed world and tightening measures in China, temporarily shook investor confidence in the global economic recovery. In that sense, the stumble in the first quarter was symptomatic of the market environment we envision going forward—risk assets will stall amid signs of aggressive policy tightening and/or growth fading, resulting in muted equity returns amid high volatility.

Growth Paradox

The policy dilemma is most pressing for EM economies. Exhibit 2 shows the divergent nature of global inflation, with inflation among the G7 economies remaining muted while EM inflation is rising, especially in Asia, where price pressures have rapidly shifted from deflationary to inflationary.

Indeed, Asian central banks have been in the vanguard of monetary tightening—Australia[3] was the first major central bank to hike policy rates, while Malaysia and India were the first among EM countries to do so. As a result, Asian equities have underperformed EM equities as a whole, with recent gains driven more by Latin America and the Europe, Middle East, & Africa (EMEA) grouping (Exhibit 1). Furthermore, the domestic Chinese A-share market has not broken to new highs, remaining more than 10% below its August 2009 level, when Chinese authorities first vocalized their concerns about loan growth and asset bubbles. Thus, EM underperformance reflects a so-called growth paradox—the more economic growth accelerates among emerging markets, the more pressure there is on policymakers to tighten policy, and the more pressure on markets to discount policy-induced headwinds.

Another interpretation is that to the extent that EM, and especially Asian, equities are highly

[3] While Australia is certainly not an emerging market, its economy has become increasingly tied to Asian, and especially Chinese, demand for raw materials.

geared to the economic cycle, their recent underperformance seemingly reflects that the *pace* of the global economic recovery is cooling—a development that may become increasingly clear over the coming quarters as the boost from stimulus measures fades. Exhibit 3 shows how closely EM performance tracks (if not leads) the rate of change in the global index of leading economic indicators (LEI), sporting a correlation of 0.76 since 1996. EM equity momentum peaked right alongside the global and Asia LEIs, and has decelerated as these growth indicators continue to roll over. While slowing LEIs from a high level do not imply a double dip is imminent, it is important to remember that equity markets are influenced more by perceptions of the pace of economic growth than the level of economic activity. And decelerating growth has historically been a headwind for EM equities.

Finally, a period of EM underperformance was inevitable given the surge from early 2009 lows. Exhibit 4 shows the rolling 12-month performance of EM equities relative to several developed markets. By last November, EM equities had outperformed developed equities by a staggering 54 percentage points over the previous 12 months, a level similar to prior peaks. While relative performance has rolled over, EM equities are far from "oversold" on a relative basis, implying mean reversion has more scope to run. Therefore, even during a mini boom that sees global growth become self-reinforcing, EM equities may continue to lag for a period as developed markets equities play catch-up and re-rate amid a stronger growth outlook.

Without reading too much into recent performance, the bottom line is that EM equities are stuck in a difficult spot in the cycle. Strong growth could lead to economic overheating and increased policy headwinds, while if growth disappoints, EM equities will likely be hit harder given their high beta/cyclical nature and the fact that current valuations are discounting strong earnings growth.

From Under- to Fully Priced

In our opinion, valuations still appear stretched and offer little cushion from potential disappointment. Exhibit 5 shows a composite valuation indicator based on the average deviation from the mean, or z-score, of the traditional metrics of trailing price-earnings (P/E), price-to-book (P/B), price-to-cash, and dividend yield ratios. At the end of 2009, EM equities were a full standard deviation overvalued on this measure, surging from 2 standard deviations undervalued in early 2009. Although this indicator has eased to below 1 standard deviation given the recent softness in the market and the fact that earnings have begun to rise, this movement stands in stark contrast to the early stages of the 2003–07 cycle, when this indicator did not reach current levels until the end of 2006—three years into a robust global recovery.

Of course, the key issue today regarding valuations is the extent to which earnings will come roaring back after bottoming late last year. Indeed, the entire global equity rally in 2009 was driven by multiple expansion in anticipation of an earnings recovery, which now seems underway. Already EM earnings per share (EPS) have risen some 20% from their lows, with current consensus analyst expectations of an additional 50% growth over the next 12 months. As a result, EM valuations appear more modest if such estimates are taken at face value, sporting a *forward P/E ratio* of only 11.8 at the end of April, in line with the average post-1994 forward P/E ratio.

However, even on a forward basis, by last autumn EM equities had reached nearly 1 standard deviation above average, with the recent moderation in valuations related more to rising earnings expectations than to easing prices.[4] Indeed, today's forward P/E ratio assumes earnings will exceed their 2008 peak (Exhibits 6 and 7). While rapid EPS growth from a low base is certainly possible, we are very skeptical of expectations for a return to peak profits so soon. To us, "average" multiples on peak earnings sound pricey, as well as vulnerable to downward revisions. Furthermore, much like our composite valuation metric, today's forward P/E ratio is back to levels not seen since late 2006/early 2007, as opposed to the below-average multiples on offer at this stage of the previous rally.

If forward earnings seem too optimistic, then what is reasonable? We prefer to look at "normalized" or sustainable full cycle earnings, and we employ three different measures in our valuation work. Exhibit 8 shows how these earnings measures compare to actual MSCI earnings over time, while Exhibit 9 shows the respective normalized P/E ratios.[5] On these three measures, EM equities trade at much higher multiples, ranging from 16.7 to 21.9, while a simple average puts EM equities at a "composite" normalized P/E ratio of 18.7.

While all of our normalized P/E metrics are within 1 standard deviation of historical norms, current valuations still subject investors to material price risk should valuations revert to fair value. At the end of April, EM equities were 16% above fair value based on our composite normalized P/E ratio reverting to its post-1994 median value, while on an ROE-adjusted P/E basis (our preferred metric[6]), EM equities were 18% overvalued, down marginally from 21% overvalued at the end of 2009. This is in contrast to February 2009, when EM equities were between 25% and 35% undervalued on our measures.

Finally, there remains notable valuation divergence among regions. Latin American and Asian equities are more expensive than the market as a whole and valued well above historical norms on an ROE-adjusted P/E basis, while EMEA valuations (which are dominated by the Russian market) remain below average (Exhibit 10). We would argue that the low valuations sported by EMEA equities are in line with the less robust economic outlook for these regions, and thus consider EMEA fairly valued.

However, the stronger fundamentals of Asia and Latin America (especially Brazil) are clearly baked in to current pricing, leaving these markets vulnerable to disappointment, while EMEA has scope for multiple expansion and therefore relative outperformance. Indeed, Latin America appears the most expensive among EM equities, sporting valuations greater than 1 standard deviation overvalued on all of the metrics we track, including on a forward P/E basis.

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[4] Given the inherent upward bias in analyst earnings estimates, forward P/E multiples are noticeably lower than trailing valuations, making it incorrect to compare forward multiples with historical average P/E ratios.

[5] We analyze sustainable earnings by looking at the ten-year average of inflation-adjusted earnings (Shiller P/E), the level of earnings implied by a trend-line linear regression (trend-line P/E), and the level of earnings adjusted for average return on equity (ROE-adjusted P/E).

[6] Given the limited data history and dynamic nature of EM economies and the changing composition of the equity index, it is admittedly difficult to arrive at a normative measure of earnings growth. The surge in EPS from a low base over the past cycle likely overstates implied trend-line earnings growth, while the depressed level of earnings over the 1999–2002 period may understate the level of ten-year real sustainable earnings. Further complicating matters, it is unclear how much of the surge in global earnings over the past cycle was simply a reflection of rising debt in the developed world, a driver we feel is unlikely to return anytime soon. Our preferred metric for EM equities is ROE-implied EPS. This measure is less beginning- and end-point sensitive than other normalized earnings, while improved corporate profitability has been a key driver of EM equities. Indeed, the recent rebound in earnings has put trailing EPS in line with our ROE-implied earnings.

The bottom line is that among global equities, EM equities have shifted the most from sharply undervalued in early 2009 to fully valued in 2010. While current valuations are within historical norms and therefore not dangerously stretched, given the uncertainty and risks in the current environment, we still view EM equities as slightly overvalued. Investors need to judge whether they are comfortable with EM equity overvaluation in the range of 15% to 20%, given the higher volatility of the asset class compared to most developed markets, where equity volatility is often assumed to be an annualized 15%. At a minimum, we view valuations as a strong head-wind, as earnings must now meet and beat expectations to drive additional expansion of multiples. Fundamentals need to catch up with current pricing.

Relative Valuations Make All the Difference

Relative valuations versus developed markets are perhaps of more importance from an asset allocation perspective. The MSCI Emerging Markets Index is trading at a 12% premium to the MSCI World Index on a P/B basis, compared to the 9% *discount* on offer in October 2008, let alone the 36% discount in 2003. Excluding U.S. equities (which we also consider overvalued), EM equities trade at a 30% premium to global equities, up from 8% in October 2008. Historically, EM equities trading at a premium to developed markets has been a warning flag. As Exhibit 11 shows, relative valuations are only slightly below the levels seen at the 2007 market peak.

We are somewhat less concerned about the lack of a steep valuation discount for EM equities this time around, as much of the discount over the 1995–2003 period was due in part to tech bubble–inflated valuations for developed markets. Furthermore, we expect some of the secular re-rating of EM equities to remain, given our view that a lower level of indebtedness among EM economies and households (outside of Eastern Europe) is a fundamental strength relative to the deleveraging taking place in much of the developed world.

Indeed, with EM ROE showing more resilience than developed markets ROE (the MSCI Emerging Markets Index generated an 11.6% ROE at the end of April, compared to 9.1% for the MSCI World Index), a case can be made that EM equities can support higher relative valuations. In other words, the shift in relative *economic fundamentals* may justify a lower relative valuation discount than in the past. If the developed world remains in a semi-slump, why should investors not pay up for growth potential?

This is precisely what took place over the previous EM "mania" of the early 1990s, when EM equities often carried valuations at par or above developed markets, particularly emerging Asian equities, which were the focus of investor interest. From 1992 to 1995, Asian equities traded at an average 20% premium to developed equities, with a peak relative valuation premium of over 70% by the end of 1993 (Exhibit 12).

In hindsight, this was clearly excessive, but like all manias, there was initially some logic behind it. During this period, the Asia Tiger economies were roaring as the developed economies were reeling in the aftermath of the early 1990s recessions brought on by the savings & loan crisis in the United States, the bursting of Japan's bubble economy, the stresses of German reunification, and the ejection of the United Kingdom from the European Exchange Rate Mechanism, among other causes.

Importantly, this divergence in economic cycles led to diverging profitability. Developed markets ROE embarked on a steady decline from 1989 to

1994, while EM and Asian ROE climbed higher. As a result of superior earnings growth, money poured into the region's relatively illiquid markets, sending prices through the roof—1993 saw the MSCI EM Index post a 75% return, its best year until 2009's slingshot 79% rebound.[7]

Exhibits 11 and 12 show how the rise in relative ROE was accompanied by the rise in relative valuations. Conceptually, a market can support a higher P/B valuation if it is achieving a higher level of ROE (more earnings are being generated for every unit of equity). However, EM equities saw their valuation premium collapse following the 1994 "Tequila crisis" in Mexico and in the lead up to the Asian financial crisis, at the same time that the developed world began to recover amid the mid-1990s tech boom.

The key point is that should divergent economic growth result in divergent profitability, EM equities can indeed support a valuation premium to developed markets, although this profitability must be sustainable. Even then, at some point the investor is simply paying too much for perceived growth. We admonish investors to remember that stronger economic growth does not always translate into superior asset returns—valuations still matter.

Exhibit 13 breaks down the drivers of returns for EM and developed markets equities over various time periods. Total returns for investors are based on income and price returns, with the price return composed of the growth in EPS (or book value) and the change in valuation multiples (P/E or P/B expansion or contraction).

Over the 1989–2007 period, EM equities produced an average annual compound return (AACR) of 15.2%, compared to 8.6% for developed markets equities. However, most investors may find it surprising that over this 19-year period, EPS growth was largely the same for both markets, at 8.4% and 7.1%, respectively. This is contrary to the idea that EM equities generate higher returns due to stronger growth. What allowed EM equities to nearly double the return of developed markets equities was valuation expansion—developed equities saw P/E ratios fall from 18.1 to 15.7 over this period, shaving 0.7 percentage points from returns annually. EM valuation multiples, meanwhile, rose from 8.6 to 17.1, adding 3.7 percentage points to returns annually.

Over the EM boom period of 1991–94, EM equities delivered stronger earnings, with 9.9% annualized EPS growth, compared to -3.0% for the MSCI World Index. This 13 percentage point differential helped drive EM total returns of 22.9% annualized, compared to only 10.2% for developed equities. Yet during the tech boom, EM equities lagged behind massively as expansion of multiples could not offset the drag from collapsing earnings and profitability resulting from the various EM crises of the late 1990s. However, this set the stage for the blockbuster returns of the following cycle.

From 2003 to 2007, EM equities generated a total return AACR of 37.5%, compared to 17.5% for developed equities, although EM earnings growth was not drastically higher—28.3% annualized, compared to 24.2% for the MSCI World Index. The fact is that 2003–07 was a global earnings boom, and companies in the developed world reaped just as much as those in emerging markets; in fact, both regions sold goods to each other.[8]

[7] Based on data from the S&P/IFC Global Stock Market Factbook, total net equity portfolio flows of $43.3 billion poured into EM in 1993, equivalent to 19% of the previous year's market capitalization of the MSCI Emerging Markets Index. For context, 2007's net equity flow of $138.6 billion accounted for only 6% of market cap.

[8] It could be argued, however, that financial sector profits in the developed markets helped drive outsized earnings growth over the last cycle, and are unlikely to return. Still, given the GDP growth differentials over the period, most

Valuations made all the difference, as EM equities began the period with a trailing P/E ratio of 14.0, compared to 23.2 for the MSCI World Index. EM equities enjoyed a 4.2% annual valuation re-rating as P/E ratios rose to 17.1, while developed markets suffered a 7.5% valuation de-rating as P/Es fell to 15.7—an 11 percentage point differential. Again, beginning valuations matter immensely.

Exhibit 11 highlights another interesting point about the 2003–07 cycle. For the majority of the previous cycle, EM equities generated a higher level of ROE than developed equities, but traded at a much lower relative valuation discount than their relative profitability would suggest was appropriate. In other words, investors were not willing to pay up for the growth prospects of EM, most likely thinking that the boom in profits was not sustainable, given lingering memories of the 1990s. It was not until 2007 that investors fully embraced the decoupling theme and started paying premium relative valuations.

Today, investors are already paying up for EM growth prospects. And to the extent that EM ROE remains structurally superior to developed markets ROE over the coming years, such a premium is justified. However, for EM equities to massively outperform going forward, they will have to deliver both better earnings growth *and* multiple expansion. While strong valuation expansion could occur if an EM mania does unfold, investors need to be aware that today's premium valuations imply that the stronger economic fundamentals of EM economies are already in the price.

investors would have assumed that profits would be higher in Asia. Investors should remember that stronger economic growth does not always translate into EPS growth.

Get Ready for a Bumpy Ride

We are still concerned that global equities, and EM equities in particular, have run too far ahead of fundamentals. Exhibit 14 shows overbought/oversold measures for the MSCI Emerging Markets Index in US$ terms based on the rolling six-month rate of change and deviation from the market's 200-day moving average, or primary trend.

The collapse over 2008 saw EM equities become more oversold than during the Asian financial crisis. The subsequent rally over 2009, however, drove equities to nearly 3 standard deviations overbought by last August, greater than the explosive run-up over 1993. While the market turbulence over the first quarter has brought our measures back to the neutral zone, implying that EM equities are no longer technically stretched, we have yet to see EM equities become oversold. With our valuation analysis suggesting that EM equities are slightly overvalued, EM equities remain vulnerable to a correction.

Exhibit 15 shows the depth and duration of EM equity declines and subsequent rallies since 1988. Current valuations are similar to, if not higher than, those seen in mid-2004 and mid-2006 when EM equities suffered 20% sell-offs over the course of a month. Both pullbacks were related to monetary tightening and inflation concerns. The parallel with 2004 is quite striking, as it also marked the beginning of a U.S. Federal Reserve (Fed) tightening after an extremely accommodative stance, and followed a powerful rally that came on the heels of a sharp bear market. The market shakeout in 2006 was prompted by fears that the Fed would tighten too much in response to rising inflation and bond yields, an outcome that may well occur if growth does surprise strongly to the upside. The 20% dip in early 1994 also coincided with the beginning of a Fed tightening cycle. As we have argued, concerns over monetary tightening, either by the Fed or EM central banks themselves, could easily prove the catalyst for a pullback.

The outlook for China, however, remains the most important variable for EM equities. A sharp slowdown in the Chinese economy, or at least fears of such a slowdown, would trigger a large repricing of the growth outlook for EM equities and commodity prices. With the Chinese economy expanding at a 12% pace over the past year and property prices climbing even faster, Chinese authorities are well aware of the need to cool growth and have recently announced a series of measures to rein in lending and property speculation.

While we do not anticipate an imminent implosion of the Chinese economy, a slowdown in Chinese growth is to some extent unavoidable and necessary to cool inflationary pressures. The majority of recent growth has been driven by "fixed asset investment" in the form of infrastructure and property development fueled by loan growth. To the extent that using debt simply pulls future demand to the present, a cooling of growth must result as authorities clamp down on lending. The assumption is that the Chinese can engineer a gradual adjustment from, say, 12% growth to 9% to 10% growth. However, should the economy continue to expand at breakneck speed, the authorities may be forced to take a much more aggressive tightening stance, which raises the odds of Chinese growth slowing more abruptly. Such an outcome is not the same as a "China bust," although it would certainly have an impact on markets and global growth assumptions.

All in all, we expect markets to become increasingly volatile over the coming quarters until there is clarity on the global growth outlook, particularly whether the Chinese economy can achieve a "soft" or "hard" landing. To a large extent, this is the key risk facing EM equities. At the same time, despite increasing talk of a "two-speed world" and economic decoupling, equity market correlations remain high, even relative to the elevated correlations seen over the past ten years (Exhibit 16). Although the travails of the developed world may still weigh on EM equities during periods of heightened risk aversion, the true test of "decoupling" is if EM equities hold their value or appreciate when developed markets suffer a pullback.

Where Could We Be Wrong?

While we firmly believe that mean reversion will eventually take hold, in the short term valuations may become more stretched and markets more overbought as the forces of sentiment and momentum feed on themselves. There are several scenarios in which our cautious stance toward EM equities could be misguided.

Importantly, if earnings continue to surprise to the upside, then current valuations are more reasonable than we think. Such a scenario could take place if a normal recovery occurs in developed economies, which see hiring and credit demand pick up. However, EM equities may still initially underperform amid such a "global boom," as relative valuations and performance indicate developed equities would benefit more from such an outcome. But rising growth and earnings momentum could spur EM outperformance.

One of the key headwinds we see facing EM equities is monetary tightening. Yet if policymakers in emerging markets choose to remain accommodative, EM valuations have the potential to climb much higher, especially if growth in the developed world remains anemic and investors continue to pour money into the EM story. Exhibit 17 shows that after a sharp drop in 2008, net inflows to EM equity mutual funds soared to $80 billion over 2009, exceeding the 2007 high by $28.8 billion. An additional $18 billion has flowed in year-to-date.

While investors should not base their investment decisions solely on the potential for a mania to form, absent meaningful monetary tightening, there is a clear risk of asset bubbles forming in the emerging world.

Currency Impact

The final piece in the EM equity puzzle is currency exposure. Indeed, investors with unhedged currency exposure to EM equities may not have noticed the recent stall, as the strength of EM currencies has compensated for lost relative equity performance (Exhibit 18). EM equities lagged the MSCI World Index by only 80 basis points over the first quarter in US$, euro, and sterling terms. Furthermore, since last summer, EM currencies have boosted EM equity returns significantly, adding nearly 900 basis points in US$ terms and even more for sterling- and euro-based investors.

Indeed, while monetary tightening may be a headwind for equities, it should be supportive of EM currencies, especially if the Chinese *renminbi* is allowed to gradually appreciate (as seems increasingly likely in the near term), thereby allowing other Asian currencies to follow suit.[9]

Thus, while we still expect EM equities to underperform this year, EM currency strength has the potential to help offset this relative weakness. We do expect long-term upward pressure on EM currencies relative to developed currencies, although any real growth scare in the global economy will see both EM equities and currencies tumble, adding to downside returns. Still, the fact that most EM currencies remain structurally undervalued relative to major developed currencies is a secular tailwind for EM equities worth taking into consideration.

[9] Please see our March 2010 Market Commentary *U.S. Dollar: The Cyclical Versus the Secular*.

Conclusion

Putting it all together, we continue to see enough near-term headwinds to retain our cautious, neutral stance toward EM equities. While valuations are not excessive, we are not sure markets are appropriately priced for the macro uncertainty we see in the current environment. Global equity markets may continue to rise in the coming months, but we judge the risk-reward trade-off to be unfavorable for an aggressive investment stance. For those investors already above desired targets in EM equities, and global equities in general, we advise rebalancing allocations back to targets should equities surge higher.

Yet given that we remain *strategically* bullish on EM equities and currencies, any large shakeout in the asset class would present a great buying opportunity. Fear of a China growth slump later this year is our prime candidate for a catalyst, although the shock to the system could come from elsewhere.

However, for those investors that are sizably underweight EM equities or that wish to increase exposure, we do not recommend trying to time the markets in anticipation of a pullback. Rather, investors should develop a plan to build exposure slowly by averaging in to positions over time, with the flexibility to contribute more capital amid a sharp pullback.

As Exhibit 15 highlights, pullbacks during EM bull markets tend to be sharp but short, taking place over one to three months, while opportunities to buy on weakness, such as the 13% decline in mid-January to early February, can disappear rapidly. Furthermore, amid a general growth scare or market panic, behavioral issues may override the signals generated by momentum and valuations indicators to rebalance or buy assets. The sad reality is that hoping to jump in at a market bottom may be the surest way to miss it.

To summarize the key points presented in this paper, we have several concerns about the current environment that have led to our cautious stance toward EM equities.

Near-term Uncertainty: The global economy is shifting gears in 2010. The withdrawal of stimulus increases economic uncertainty, leading to increased market volatility and muted asset returns.

Policy-induced Headwinds: The stronger the economic growth, the more pressure to withdraw stimulus and the more pressure on markets. EM equities face the most pressure from this growth paradox.

Stretched Valuations: Unlike the last cycle, EM equities do not have a valuation tailwind. Stronger economic fundamentals are already in the price.

Vulnerable Markets: The risk of a correction remains. Aside from monetary tightening headwinds, the risk of a China "growth scare" is rising, especially if policy is tightened aggressively.

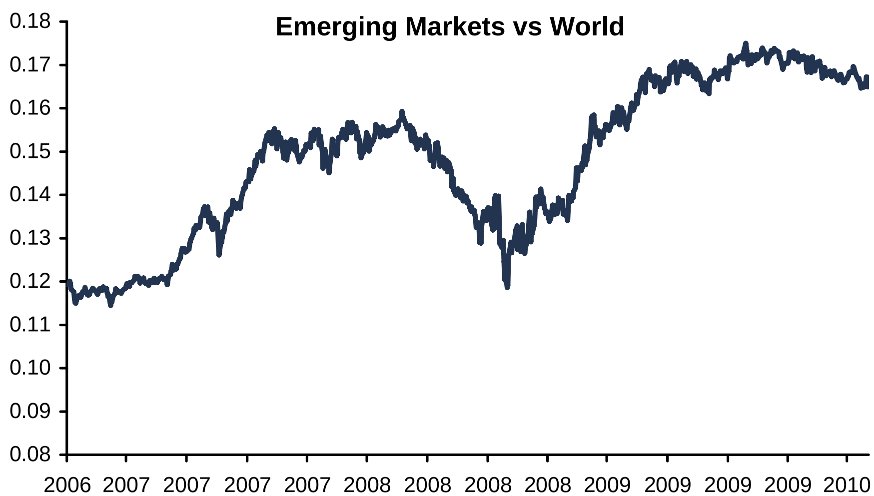
Currency Fluctuations: Strong EM currencies have helped offset recent equity weakness. We expect EM currencies to appreciate versus developed currencies over the long term, but amid a global growth scare, EM currencies will likely weaken and negatively impact returns.

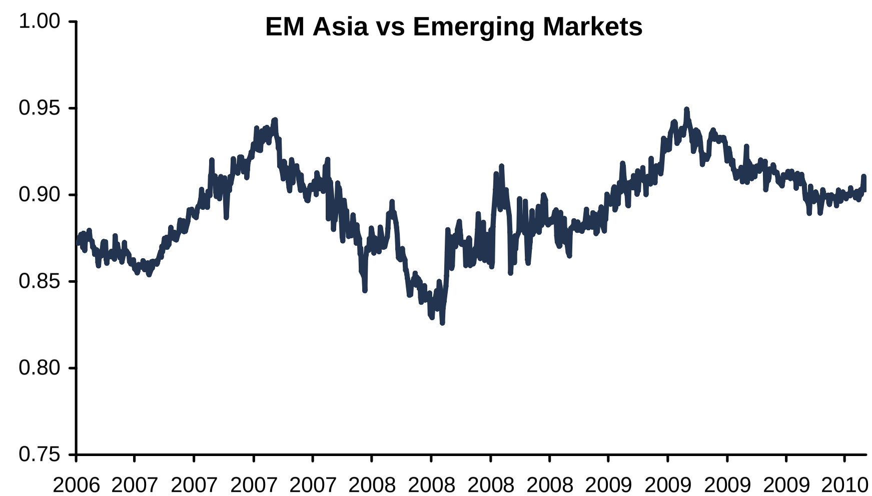
As noted earlier, there are scenarios where our cautious stance could be misguided, including an environment where further gains are driven by exceptional EPS growth and a global mini boom. An EM mania is likely absent meaningful tightening by policymakers and/or amid weak developed market growth. Given all the uncertainty, now is not the time to be aggressive. Those wishing to add exposure should go slow and average in. Do not be tempted to market time—pullbacks tend to be sharp and short. ■

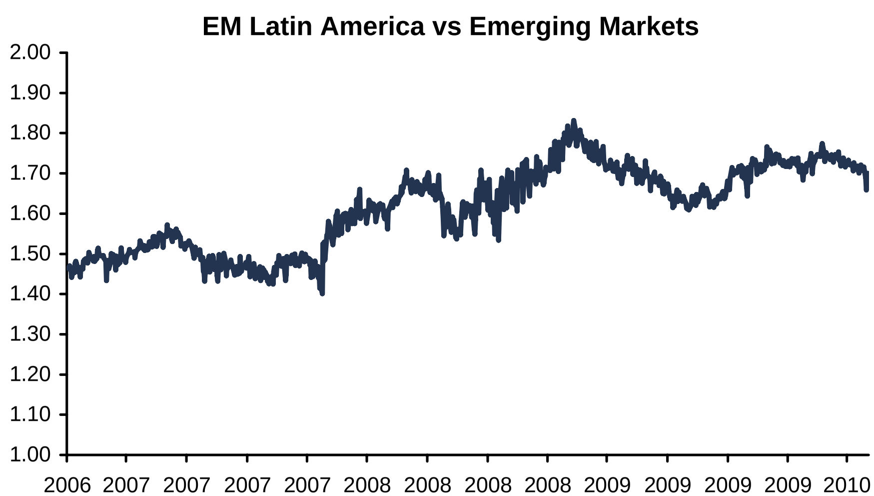
Exhibit 1

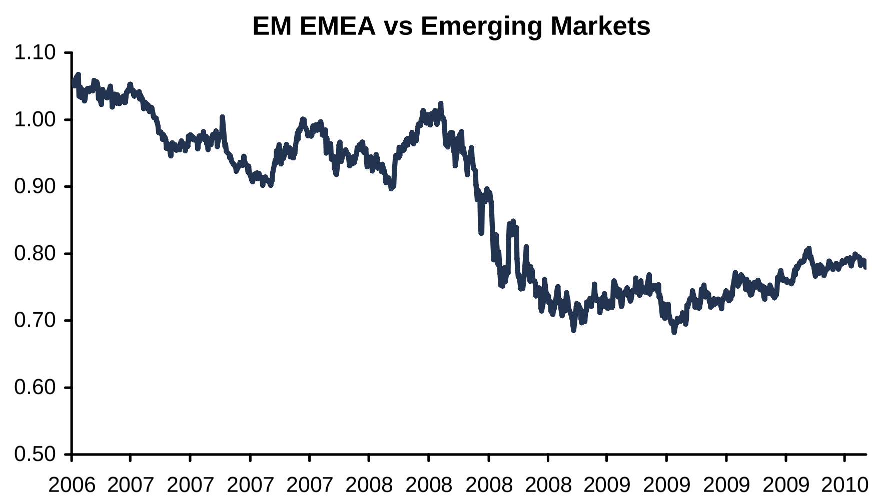
Relative Index Levels

December 31, 2006 – April 30, 2010 • Local Currency







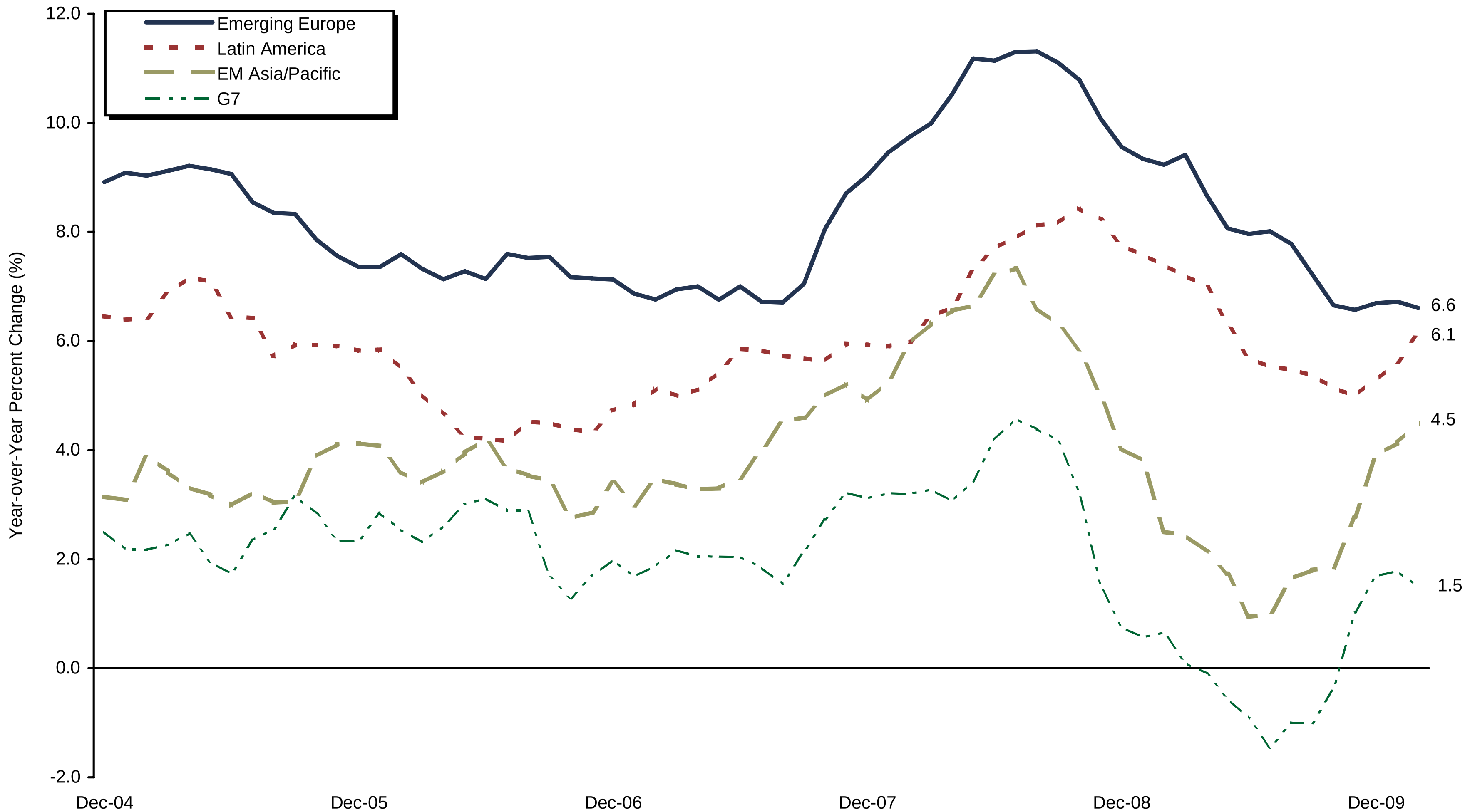


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Exhibit 2

Regional Headline Inflation Trends

December 31, 2004 – February 28, 2010



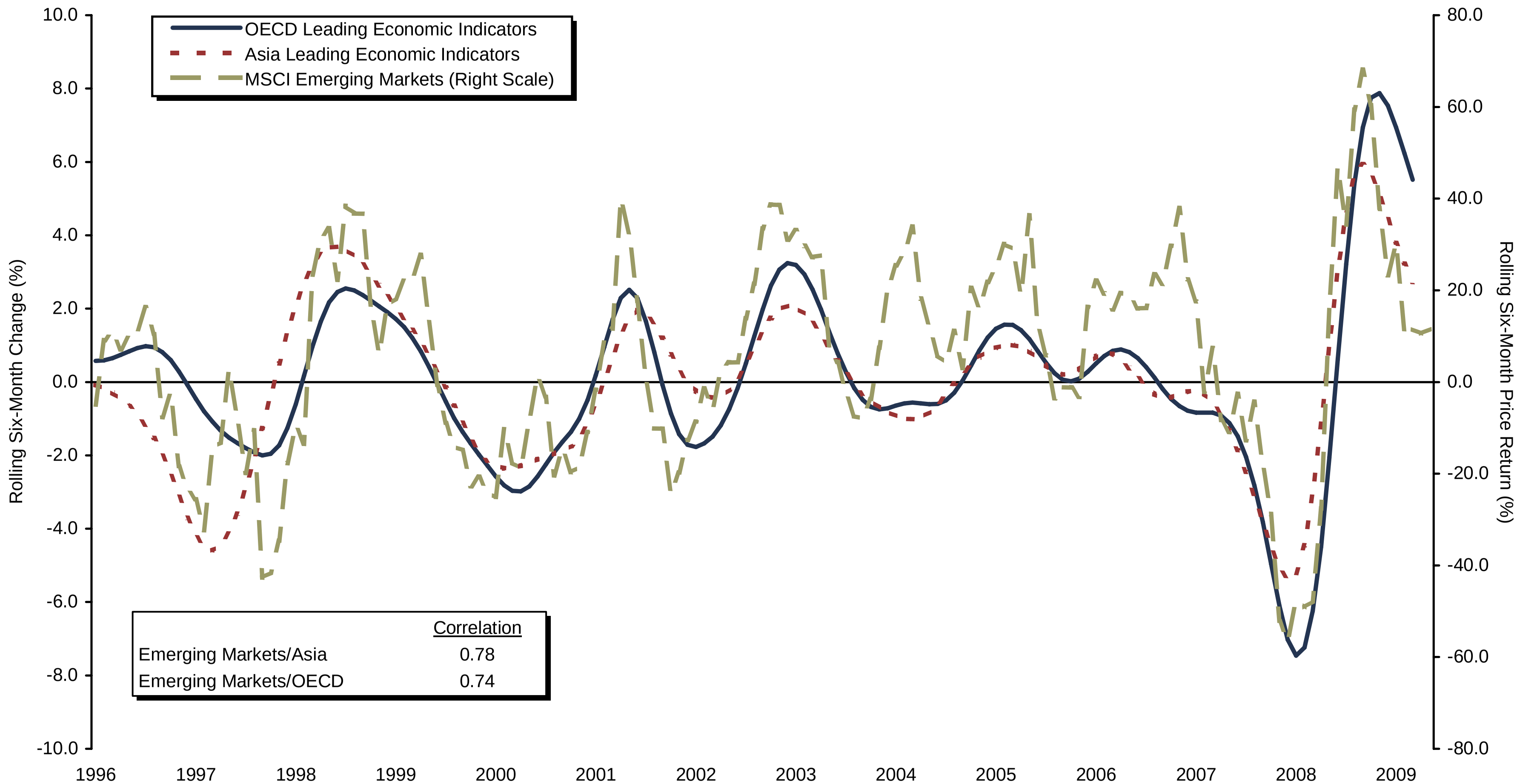
Sources: FactSet Research Systems, OECD, and Thomson Datastream.

Notes: Brazil's December 2009 data are currently not available. Inflation figures for Latin America, emerging Europe, and EM Asia/Pacific are calculated as the weighted average of country price changes. Weights are based upon 1997 US$ real GDP. G7 data provided by the OECD.

Exhibit 3

Emerging Markets Versus Leading Economic Indicators

December 31, 1996 – April 30, 2010



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

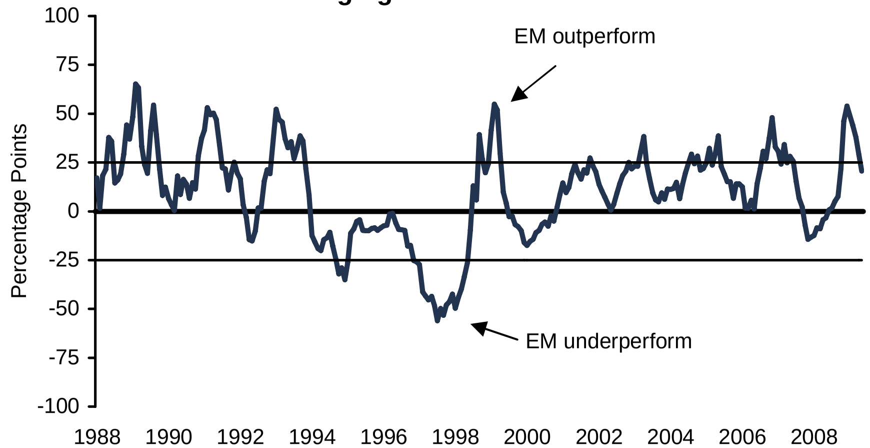
Notes: The OECD composite of leading indicators covers a wide range of economic indicators designed to signal turning points in the economic cycle. OECD composite covers 29 economies, including the Eurozone, Japan, the United Kingdom, the United States, and other members of the OECD. The Asia leading indicators data cover China, India, Indonesia, Japan, and Korea. Data for OECD and Asia leading indicators are through February 2010.

Exhibit 4

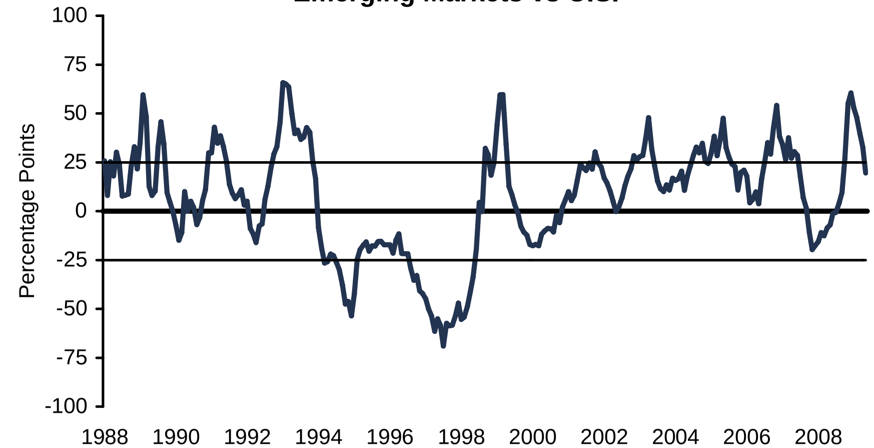
Rolling 12-Month Relative Performance

December 31, 1988 – April 30, 2010 • U.S. Dollar

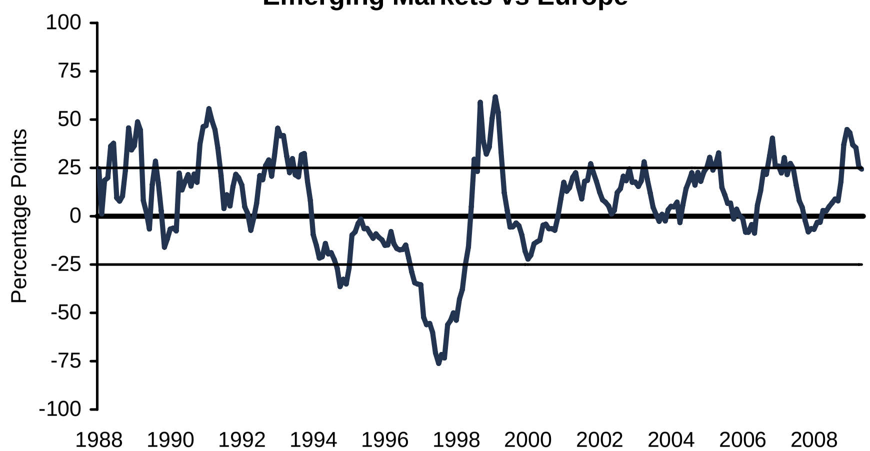
Emerging Markets vs World



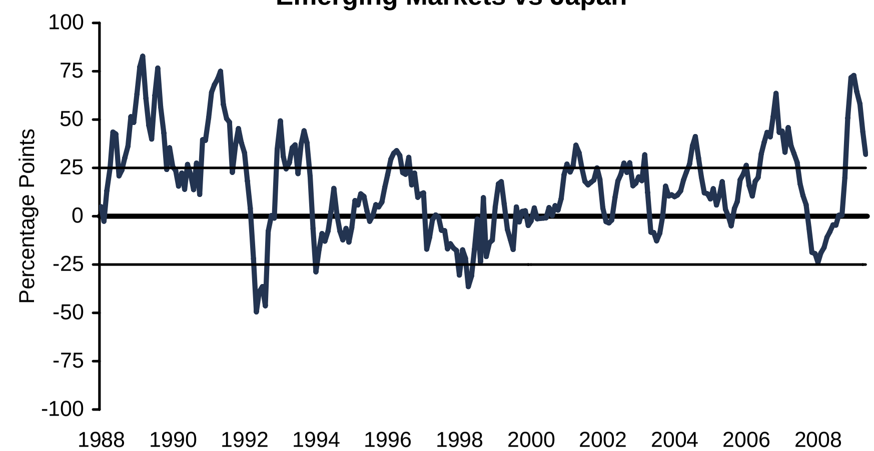
Emerging Markets vs U.S.



Emerging Markets vs Europe



Emerging Markets vs Japan



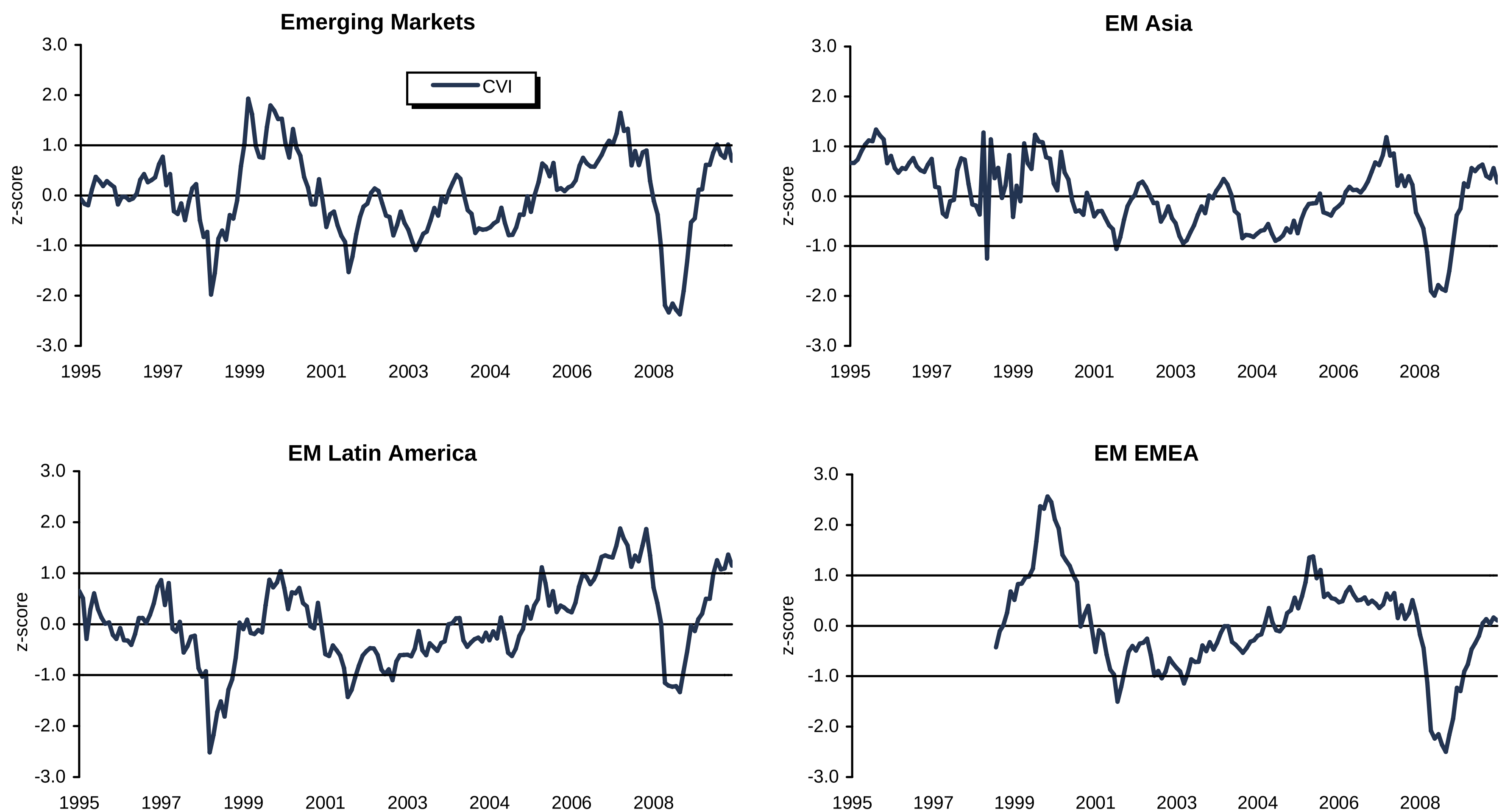
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

Note: Graphs show the percentage point difference between the rolling 12-month total return of emerging markets and each market in U.S. dollars.

Exhibit 5

MSCI Emerging Markets Composite Valuation Index

September 30, 1995 – April 30, 2010



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

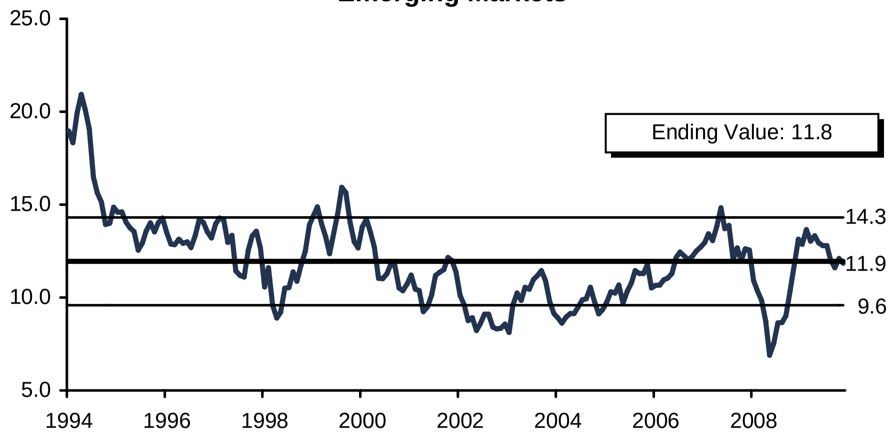
Notes: Composite Valuation Index (CVI) is calculated by taking a simple average of the z-score for price-earnings ratio, price-to-book ratio, price-to-cash ratio, and dividend yield. EM EMEA data begin on December 31, 1998.

Exhibit 6

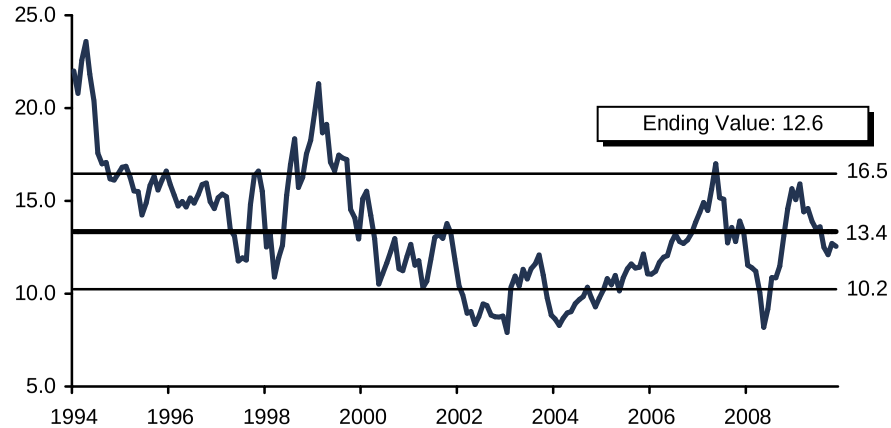
Forward Price-Earnings Ratios

June 30, 1994 – April 30, 2010

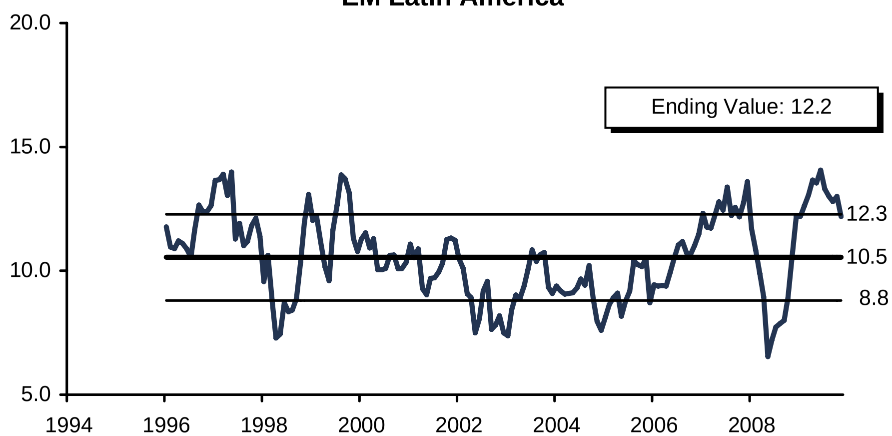
Emerging Markets



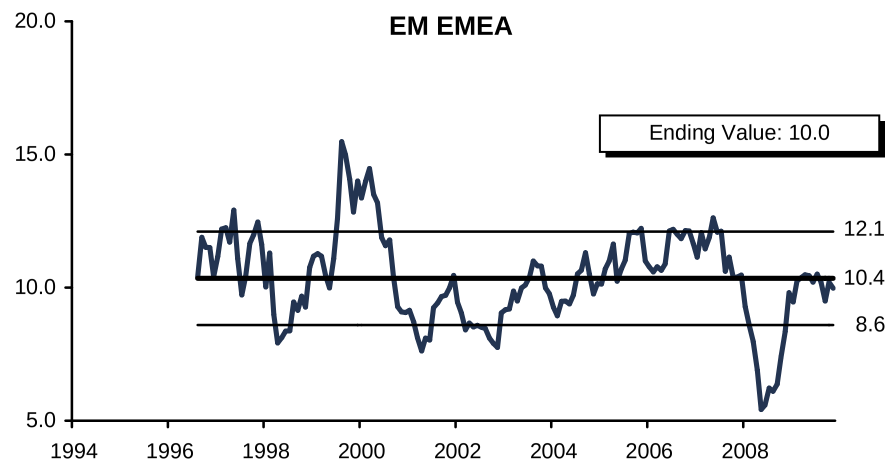
EM Asia



EM Latin America



EM EMEA

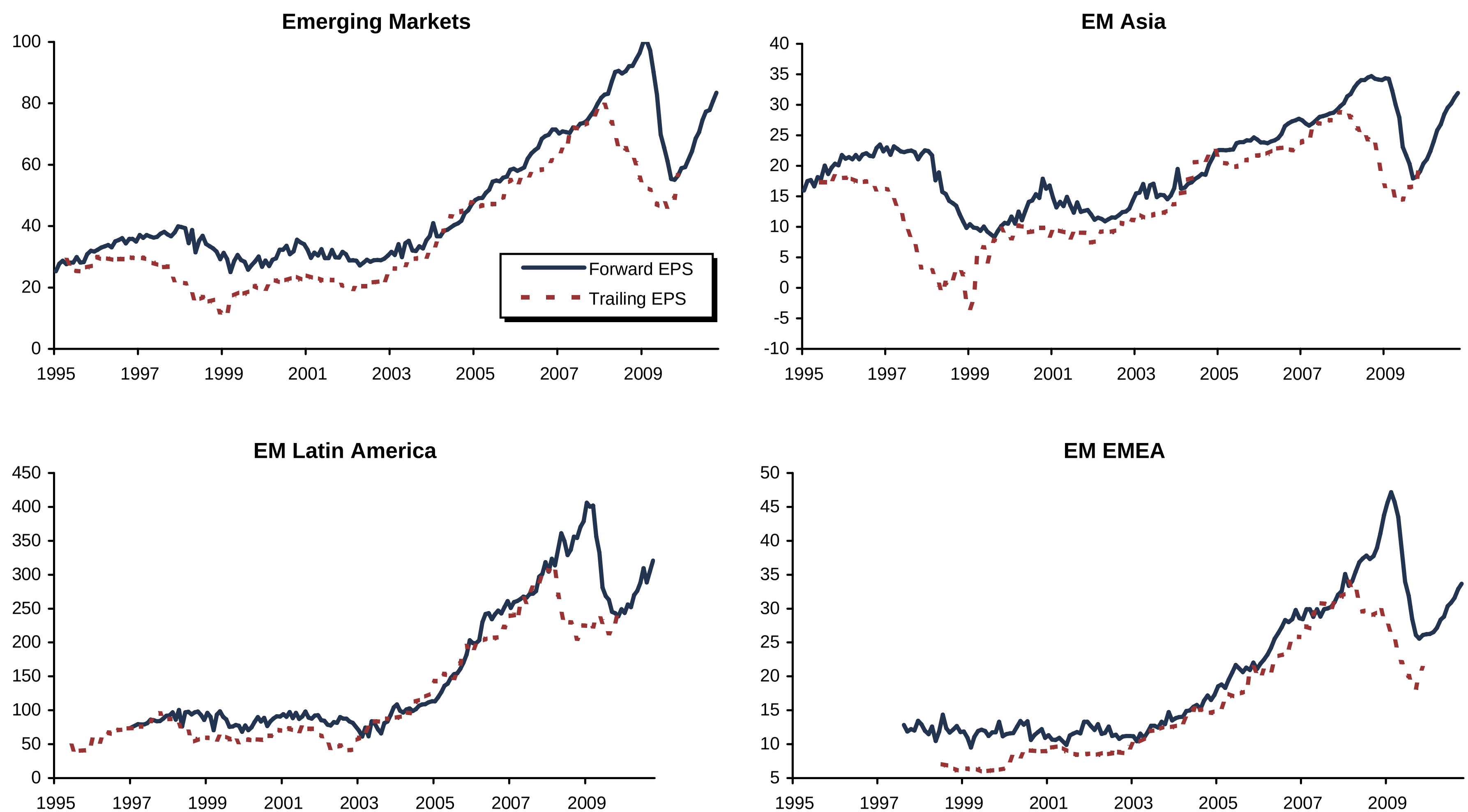


Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.
Note: Data for EM Latin America and EM EMEA begin on June 30, 1996, and January 31, 1997, respectively.

Exhibit 7

Forward Earnings Estimates

June 30, 1995 – April 30, 2010



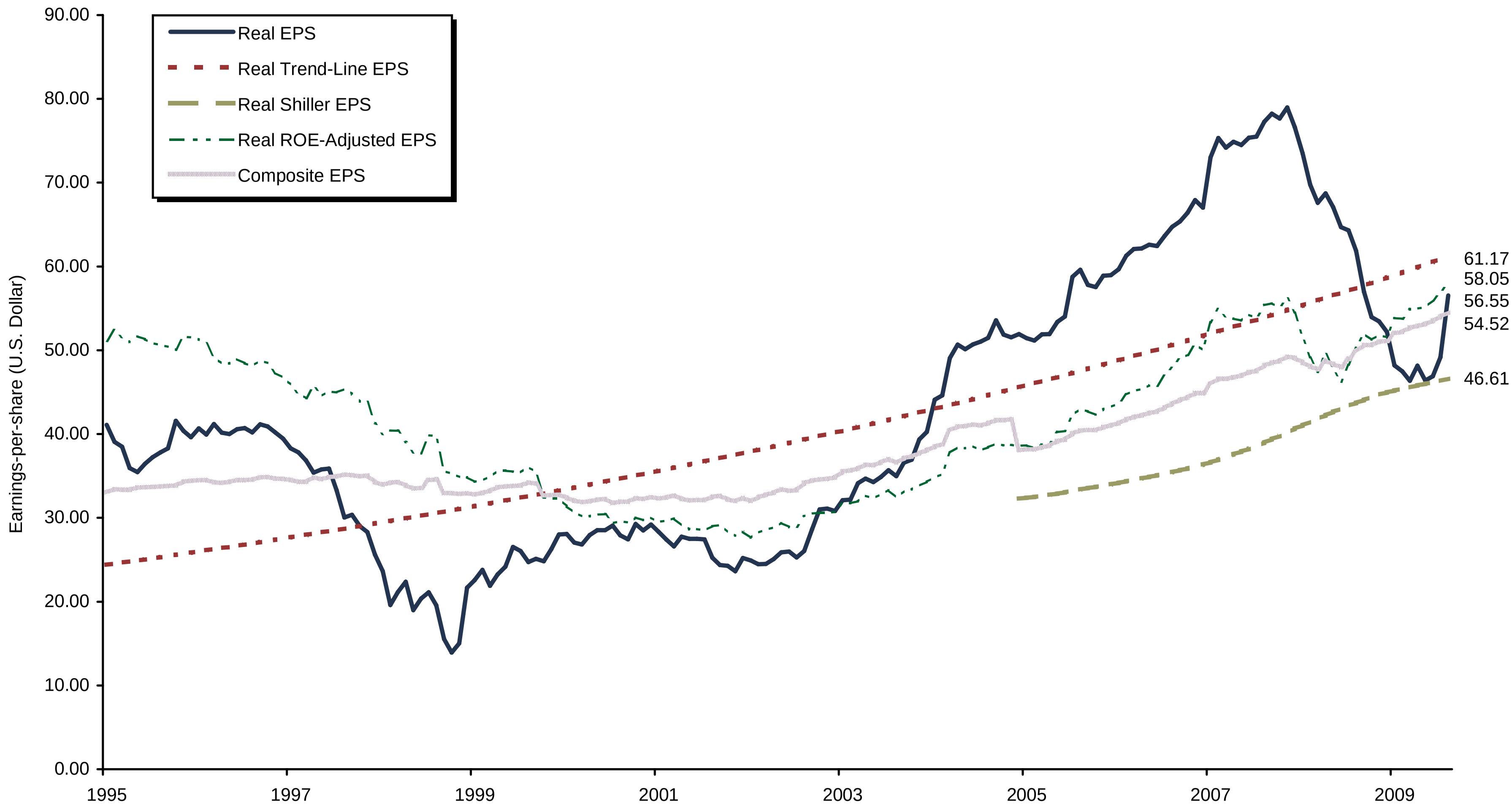
Sources: FactSet Research Systems and MSCI Inc. MSCI data provided "as is" without any express or implied warranties.

Note: Forward earnings per share are graphed leading by 12 months.

Exhibit 8

Emerging Markets Earnings Analysis

September 30, 1995 – April 30, 2010



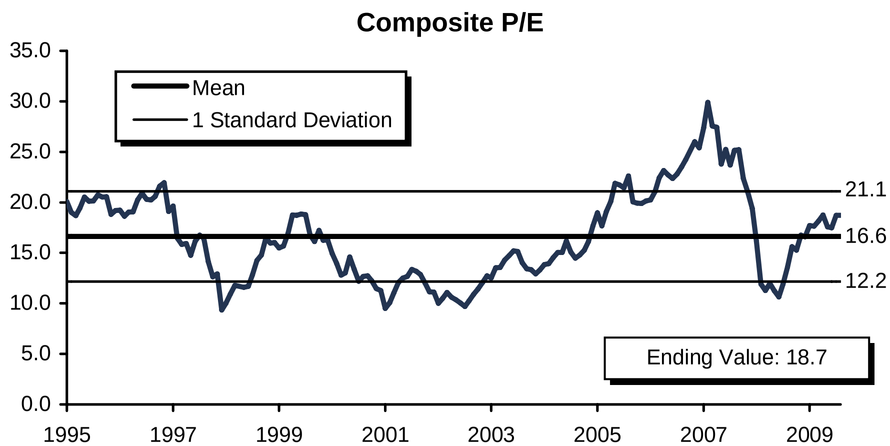
Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.

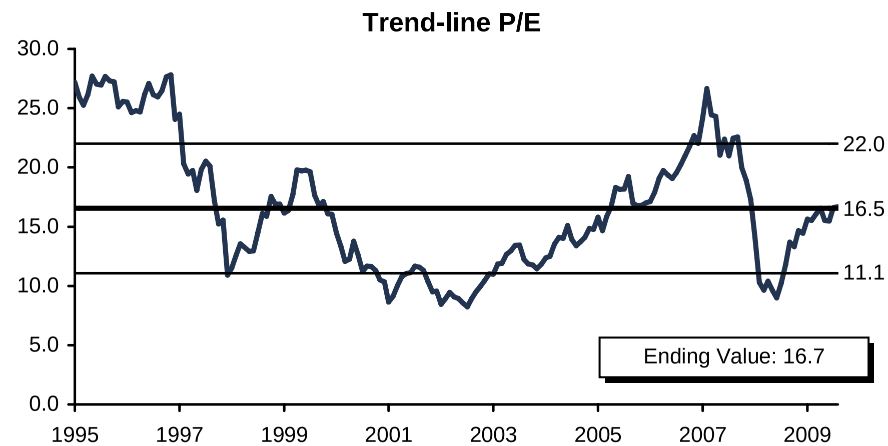
Note: Composite earnings per share (EPS) are calculated by taking a simple average of real trend-line EPS, real Shiller EPS, and real return on equity–adjusted EPS. All data are in U.S. dollars.

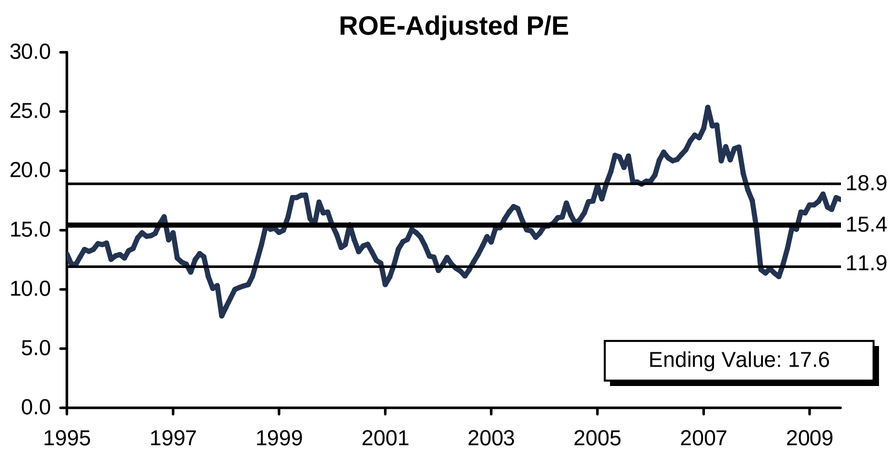
Exhibit 9

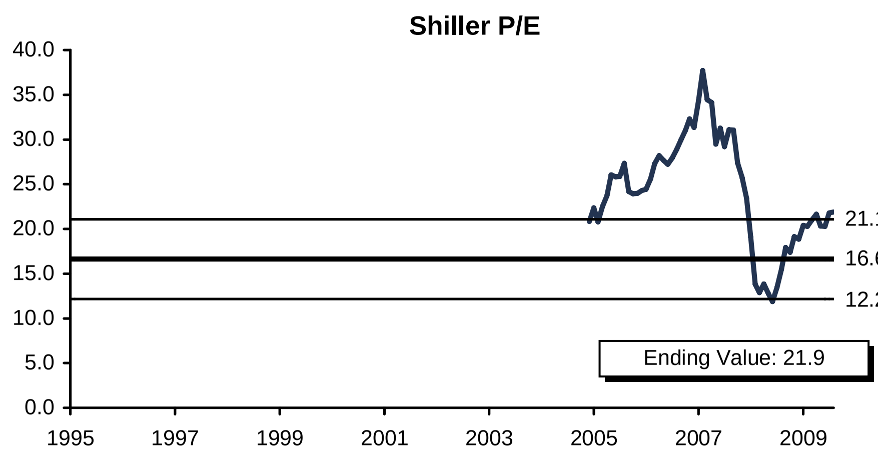
MSCI Emerging Markets Price-Earnings Valuations

September 30, 1995 – April 30, 2010









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

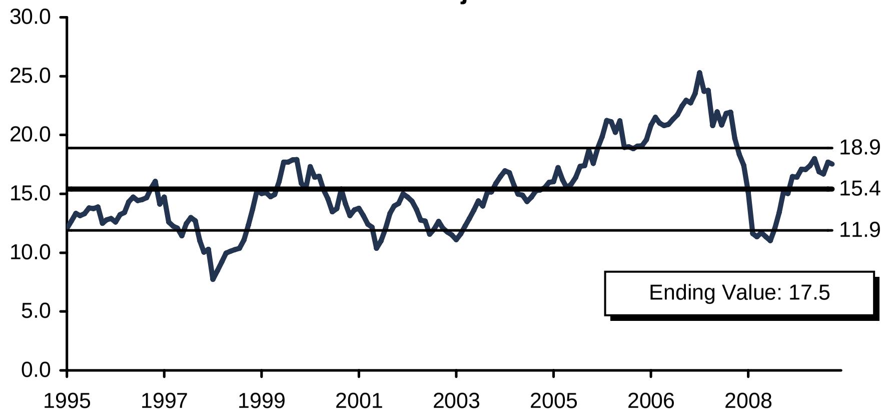
Notes: MSCI Emerging Markets earnings per share are deflated by the U.S. CPI. The composite price-earnings (P/E) ratio is a simple average of the trend-line P/E, return on equity–adjusted P/E, and Shiller P/E. Due to the limited history for the Shiller P/E, we have plotted the mean and standard deviations for the composite P/E on the Shiller P/E graph.

Exhibit 10

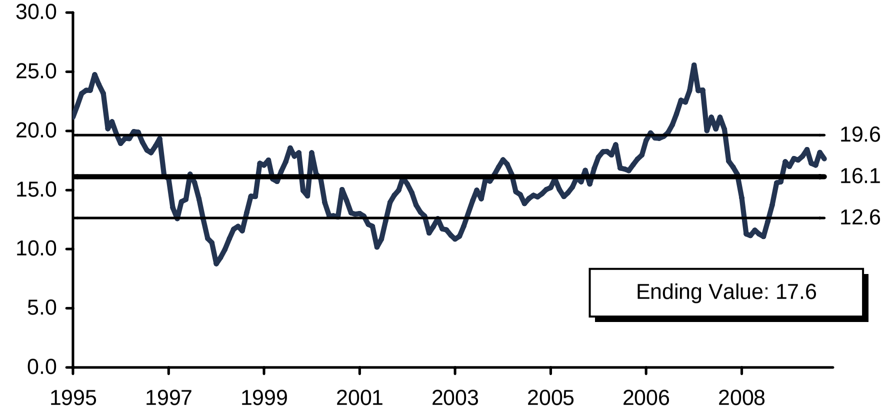
MSCI Emerging Markets Regional Price-Earnings Valuations

November 30, 1995 – April 30, 2010

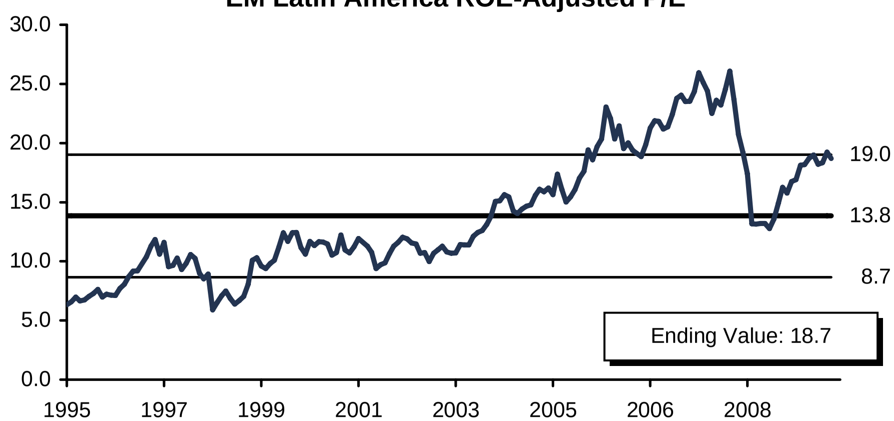
EM ROE-Adjusted P/E



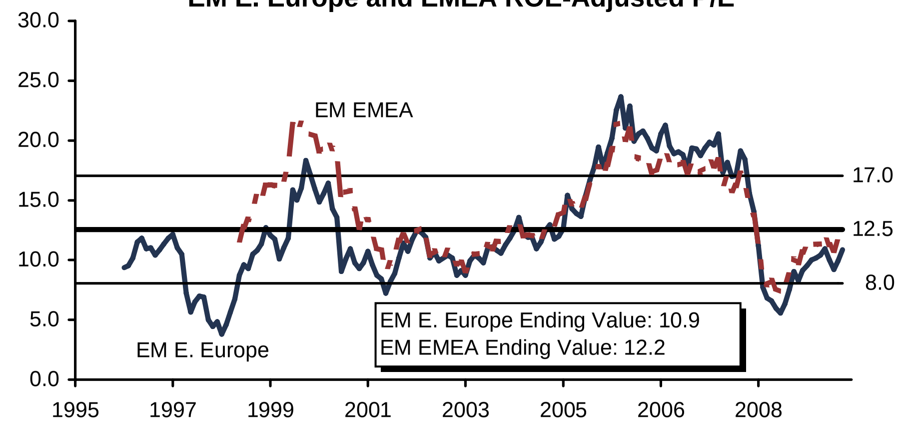
EM Asia ROE-Adjusted P/E



EM Latin America ROE-Adjusted P/E



EM E. Europe and EMEA ROE-Adjusted P/E



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 the long-term historical average ROE, except for EM Asia, which uses 12.0 as its assumed historical average ROE. Mean and standard deviation values on EM Eastern Europe/EM EMEA graph refer to EM Eastern Europe. Data for EM Eastern Europe and EM EMEA begin on October 31, 1996, and December 31, 1998, respectively.

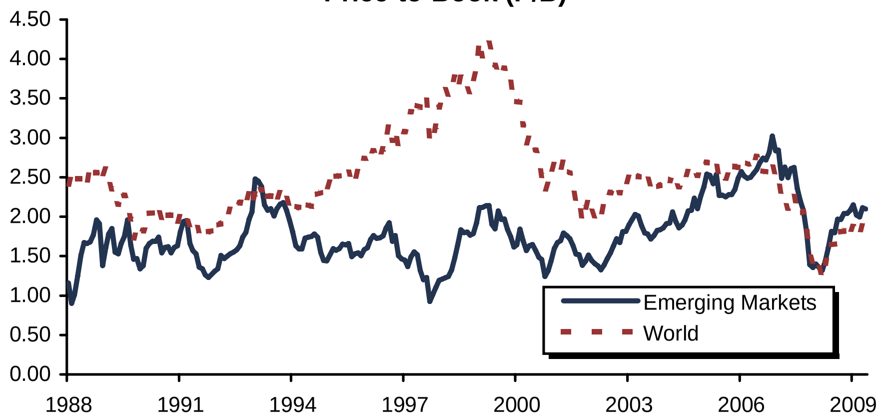
916m

Exhibit 11

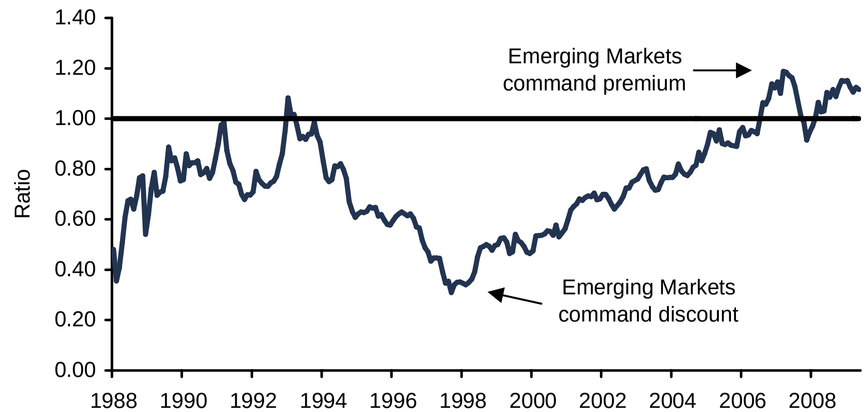
Emerging Markets Relative Valuation

December 31, 1988 – April 30, 2010

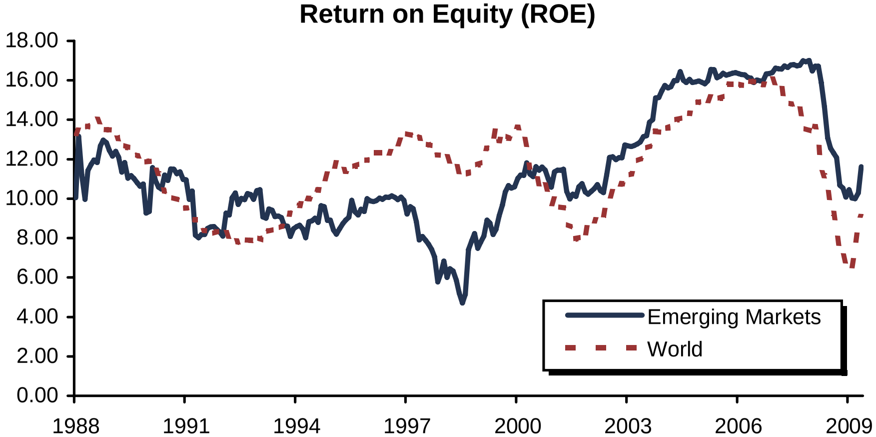
Price-to-Book (P/B)



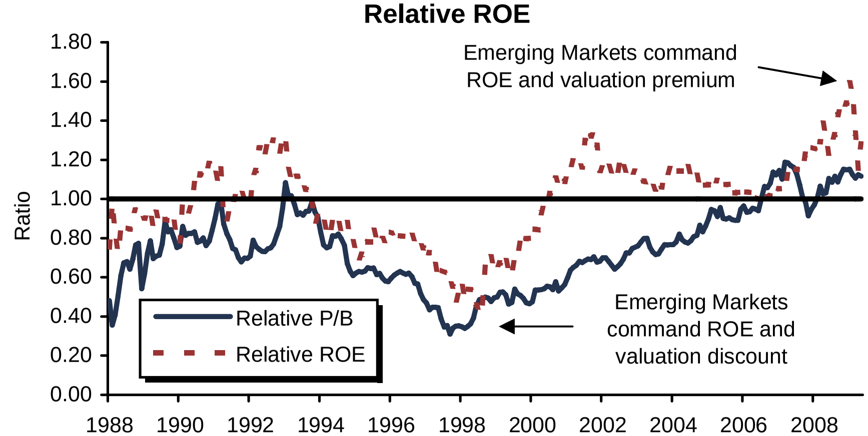
Relative P/B



Return on Equity (ROE)



Relative ROE



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

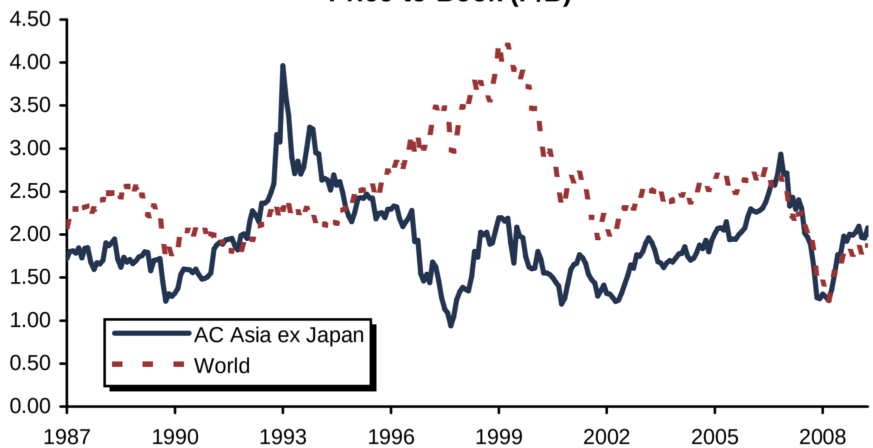
Notes: Relative valuation graphs show MSCI Emerging Markets valuation as a percentage of USCI World's valuation. For emerging markets valuations, the S&P IFCI Composite Index is used until August 1995; the MSCI Emerging Markets is used thereafter.

Exhibit 12

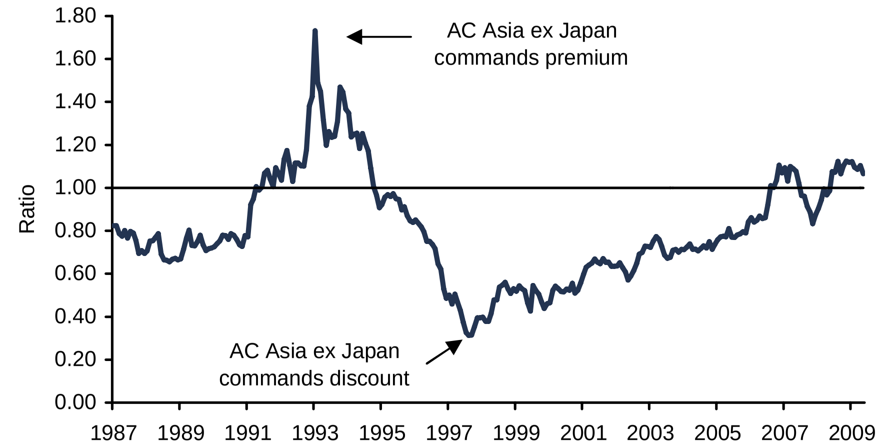
Asia ex Japan Relative Valuation

December 31, 1987 – April 30, 2010

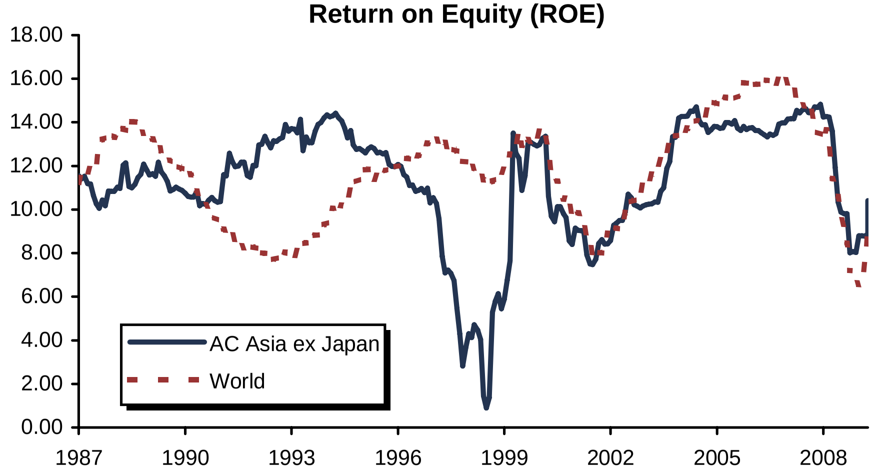
Price-to-Book (P/B)



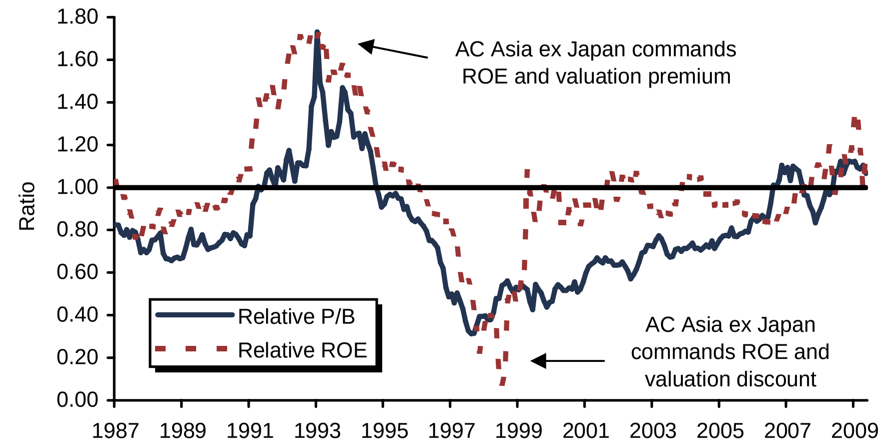
Relative P/B



Return on Equity (ROE)



Relative ROE



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Relative valuation graphs show MSCI All Country Asia ex Japan's valuation as a percentage of MSCI World's valuation.

Exhibit 13

Drivers of Return

Average Annual Compound Returns • U.S. Dollar

			MSCI World	MSCI Emerging Markets
Full Period (19 years)				
Start Date	End Date			
12/31/1988	12/31/2007			
		Total Return	8.6	15.2
		Income Return	2.1	2.5
		Price Return	6.3	12.4
		Earnings Growth	7.1	8.4
		Valuation Expansion	-0.7	3.7
		Beginning P/E	18.1	8.6
		Ending P/E	15.7	17.1
1990s Emerging Markets Bubble (4 years)				
Start Date	End Date			
12/31/1990	12/31/1994			
		Total Return	10.2	22.9
		Income Return	2.4	2.2
		Price Return	7.6	20.2
		Earnings Growth	-3.0	9.9
		Valuation Expansion	11.0	9.3
		Beginning P/E	15.3	14.8
		Ending P/E	23.2	21.1
Tech Boom (4 years)				
Start Date	End Date			
12/31/1995	12/31/1999			
		Total Return	20.0	3.9
		Income Return	1.8	2.2
		Price Return	17.9	1.7
		Earnings Growth	3.7	-8.2
		Valuation Expansion	13.8	10.8
		Beginning P/E	21.3	18.0
		Ending P/E	35.7	27.2
Global Rally (5 years)				
Start Date	End Date			
12/31/2002	12/31/2007			
		Total Return	17.5	37.5
		Income Return	2.3	2.9
		Price Return	14.9	33.7
		Earnings Growth	24.2	28.3
		Valuation Expansion	-7.5	4.2
		Beginning P/E	23.2	14.0
		Ending P/E	15.7	17.1

Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Based on trailing earnings per share. Figures are expressed as average annual compounded rates.

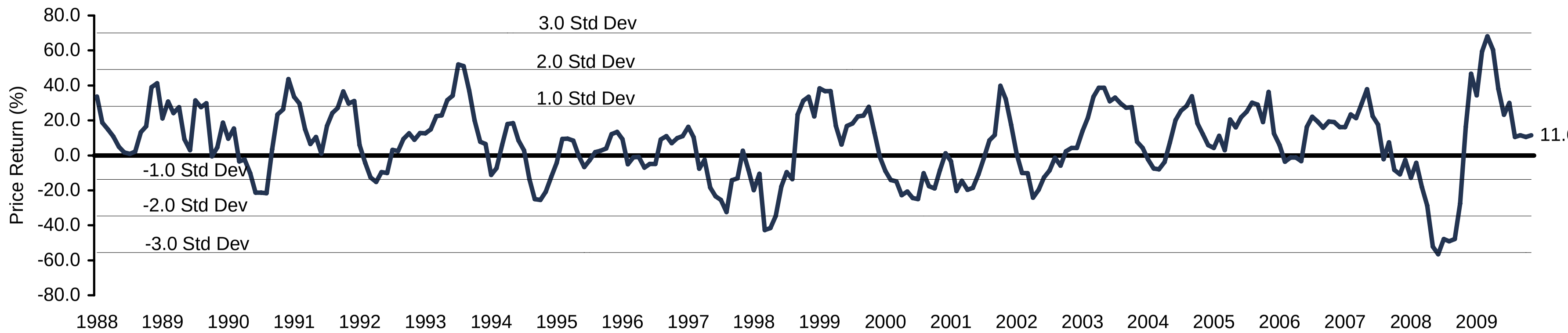
Exhibit 14

MSCI Emerging Markets Index Momentum

U.S. Dollar

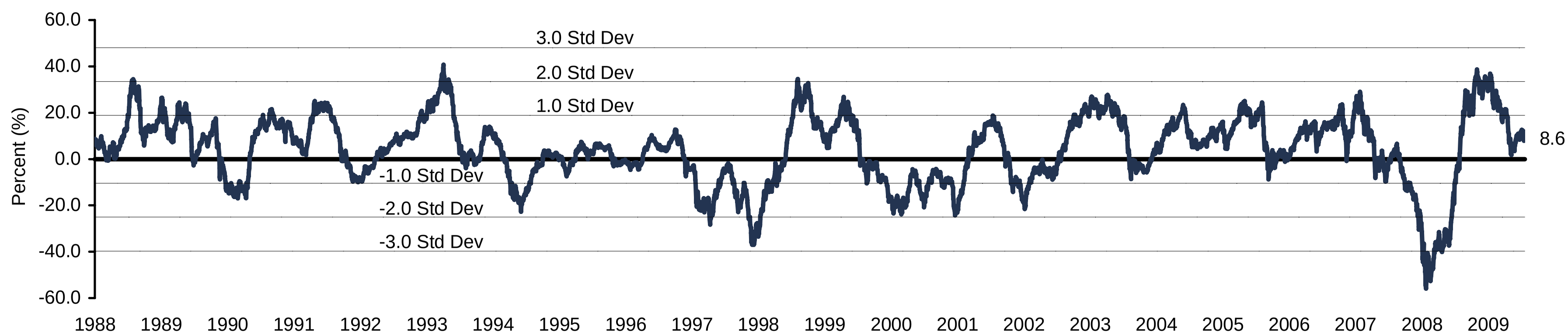
Rolling Six-Month Performance

June 30, 1988 – April 30, 2010



Percentage From 200-Day Moving Average

October 5, 1988 – April 30, 2010



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

Notes: The top graph is based on monthly price returns in U.S. dollars. The bottom graph is based on daily price levels in U.S. dollars.

Exhibit 15

MSCI Emerging Market Equities Declines and Subsequent Rallies

January 1, 1988 – April 30, 2010

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[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	114.7[2]	13.9[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 March 31, 2010. 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 April 30, 2010, but does not imply the market has reached its peak.

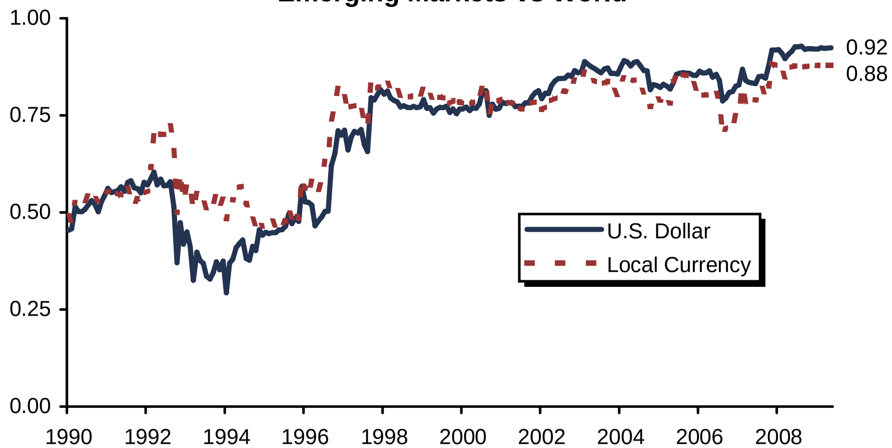
524m

Exhibit 16

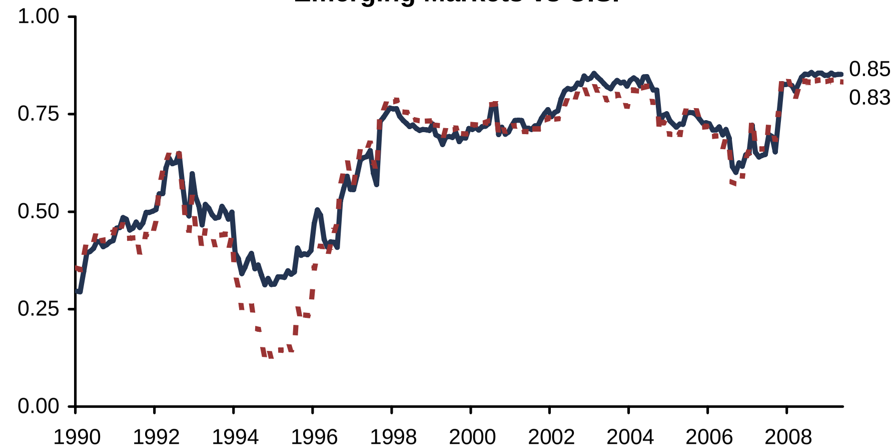
Emerging Markets Rolling 36-Month Correlations

December 31, 1990 – April 30, 2010

Emerging Markets vs World

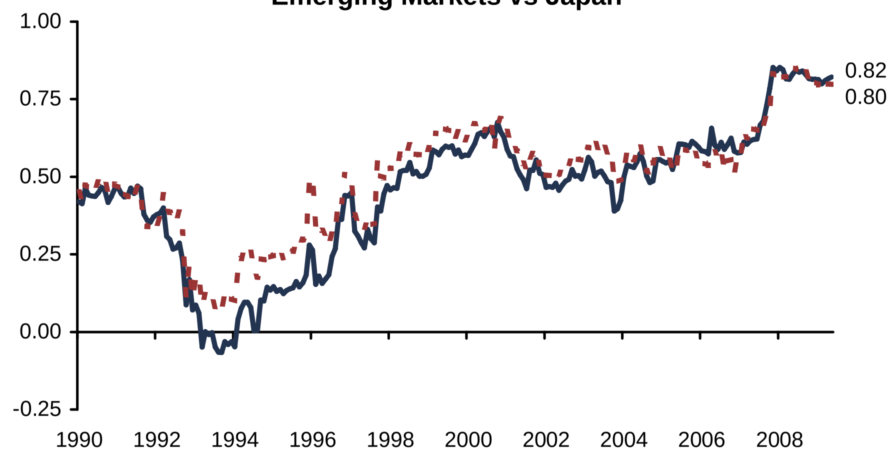


Emerging Markets vs U.S.



Emerging Markets vs Europe

Emerging Markets vs Japan

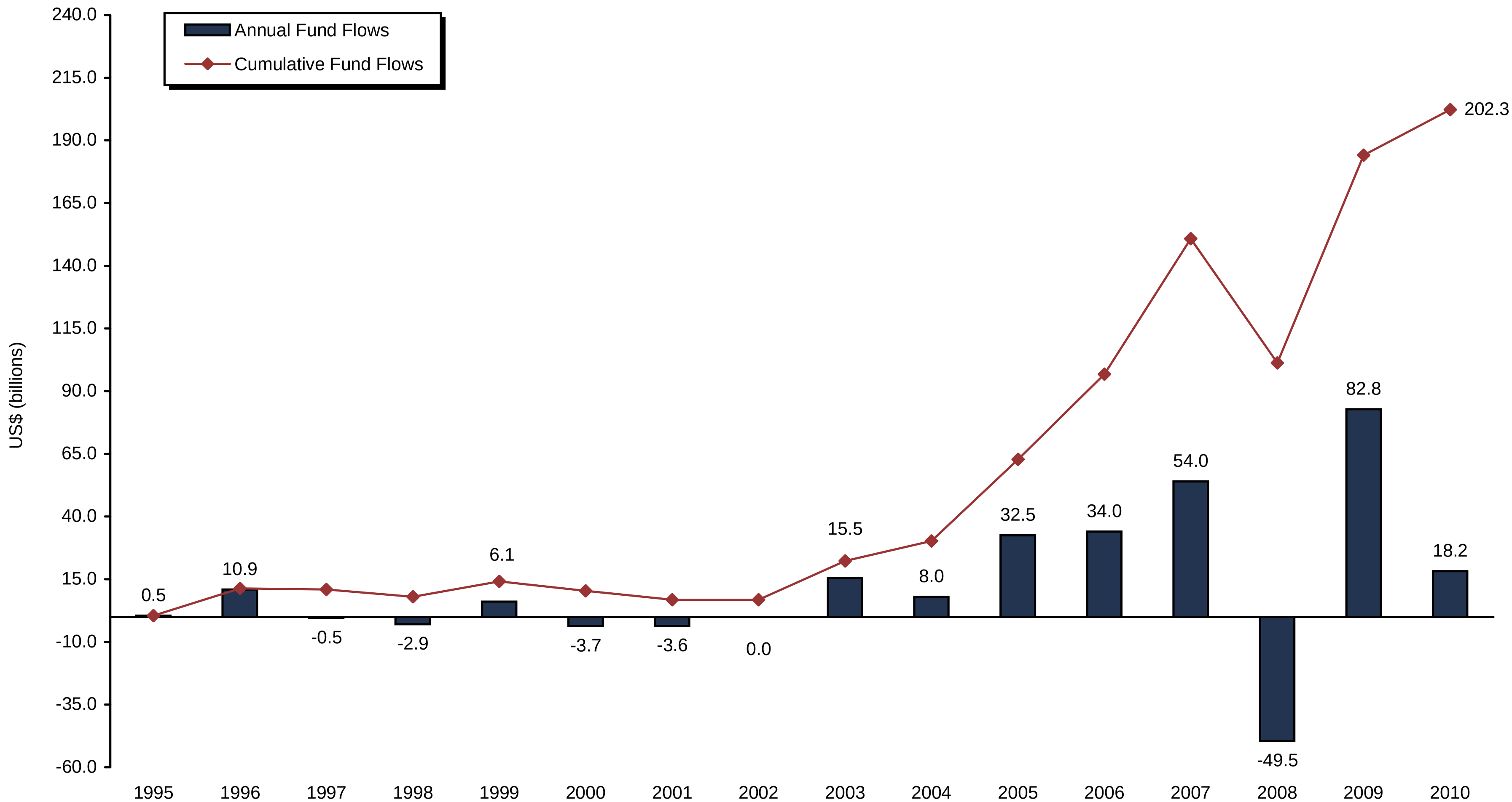


Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Data are based on monthly total returns in U.S. dollars for each region.

Exhibit 17

Net Annual and Cumulative Inflows into Emerging Markets Funds

1995–2010



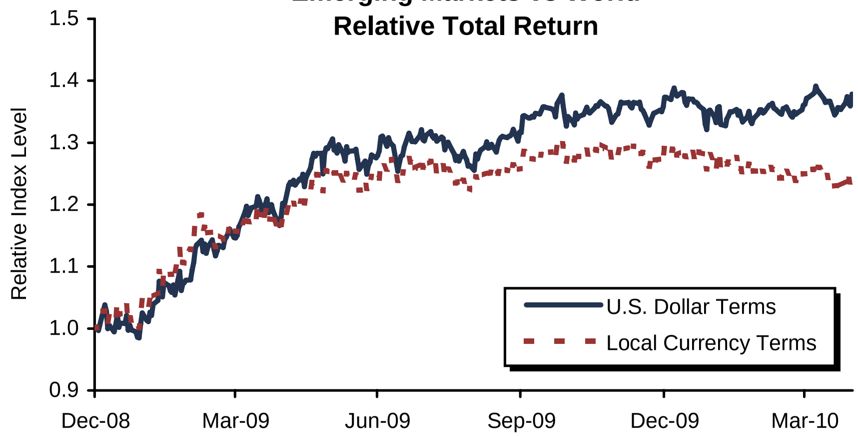
Sources: EPFR Global and Morgan Stanley Research.

Notes: Fund flows cover all dedicated emerging markets equity funds. Data for 2010 are through April 30.

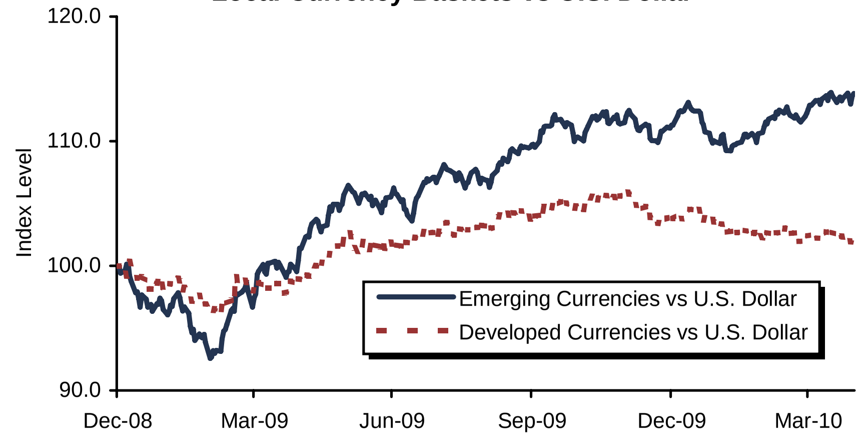
1865m

Exhibit 18
Currency Impact
December 31, 2008 – April 30, 2010

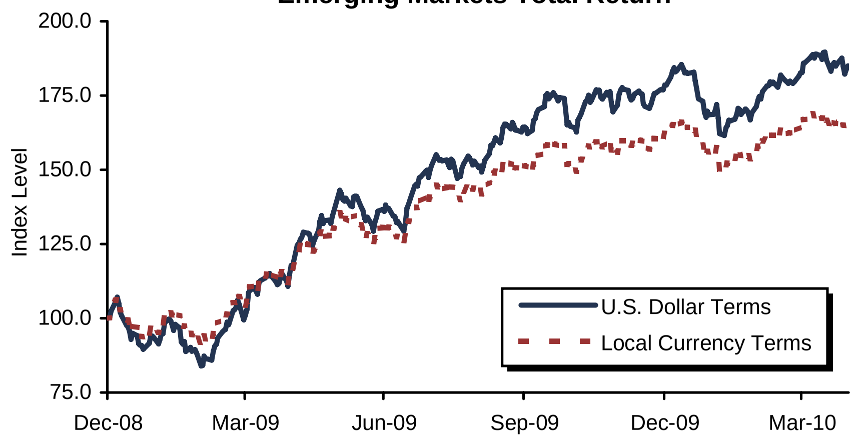
Emerging Markets vs World Relative Total Return



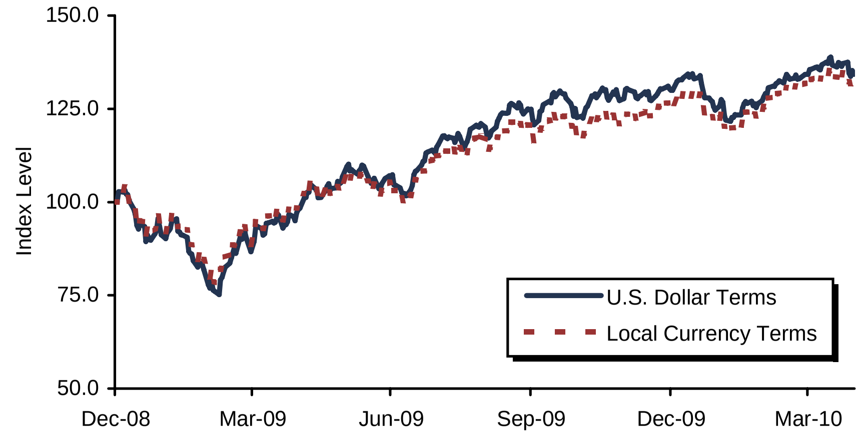
Local Currency Baskets vs U.S. Dollar



Emerging Markets Total Return



World Total Return



Sources: MSCI Inc. and Thomson Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: Local currency baskets are the cumulative differential between returns for the index in local currency terms and the corresponding returns in U.S. dollars. Thus, they represent the movement of local currencies weighted by each country's market capitalization in the MSCI index. All index levels have been rebased to 100 at December 31, 2008.