# Emerging Markets Equities—Still a Good Thing

The substantial fund flows into emerging markets equities over the past couple of years—nearly $100 billion in 2010 alone—have now swung in the opposite direction. In the last two months, many investors have been taking profits and reallocating assets to developed markets, whose prospects are improving while inflation creates headwinds in the emerging economies. Emerging markets have also seen a shift from domestic-based growth drivers to more global influences. These changes are reflected in equity performance, with the formerly red-hot emerging markets lagging the developed markets year-to-date.

While the developed countries continue to benefit from economic stimulus measures, emerging markets have been facing concerns about inflation and monetary tightening. The emerging economies are experiencing rising cyclical inflation due primarily to a spike in food and energy prices over the last six months. This bout of inflation is expected to be short term, especially as new crops start boosting the food supply this spring. Furthermore, even with the increasing wages in emerging markets, core and structural inflation—which excludes food and energy prices—remains well controlled in most of these countries.

Government and regulatory authorities in India, China, Brazil and elsewhere have already aggressively tightened their fiscal and monetary policies. Downgrades in GDP growth estimates for China suggest that these steps have been effective in preventing overheating. We expect the inflation-fighting efforts in emerging markets to continue. As inflation worries in the emerging world ease, investors should begin to recognize the increasing possibility of tightening in the developed world. The emerging economies, in our view, remain leading indicators in global markets.

We consider the current underperformance in emerging markets unusual. They have fallen behind developed markets during a rising market environment in only one year of the past 20—in 1996, after the Mexican crisis. From a short-term perspective, they have lagged developed markets by 10% or more just five times since the last bull market of October 2002, and only this time has it occurred while markets have been climbing.

In our opinion, the positive long-term structural drivers that have favored emerging markets over developed markets remain intact, and the current performance reversal, tied to cyclical drivers, will be relatively short-lived. In fact, we have begun to see signals of a possible turnaround. The MSCI India Index corrected about 20% from the high on November 10, 2010 to the low of February 10, 2011. Although we believe that it is still too early to call a bottom for India, many strategists have said that the typical bull-market correction is 15-20%, and we are in that range. We are also slightly encouraged that MSCI India has gained 7.6% from February 10 to March 2. This could have broader market implications since India, along with China, have been leading indicators in the past.

The rotation may be nearing an end. In the meantime, however, investors can benefit. We believe that a periodic downturn in emerging markets can provide an opportunity to purchase promising stocks at excellent prices—an approach that has historically worked well for those with a long-term horizon. Valuations are still quite favorable. Analysts have begun to upgrade earnings estimates, and stocks have become even cheaper in recent months relative to those in developed markets. We continue to see many attractive opportunities, particularly among companies linked to domestic demand and infrastructure development.

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