

## Emerging Markets Equities: Boom or Bubble?

*The dramatic rise in emerging markets equities beginning in 2009 has raised questions about a possible market bubble and subsequent collapse. Many investors are also wondering how policy changes in China will affect emerging markets as a whole.*

*Ray Prasad, Senior Portfolio Manager on BatteryMarch's emerging markets investment team, answers some frequently asked questions:*

### **How soon will the monetary tightening process be completed in China?**

We expect China to continue a gradual withdrawal of its stimulus programs over the next 12 to 18 months, although officials are unlikely to raise interest rates in the near term. They will be monitoring the global economy, looking for improvements in export demand before removing their domestic growth drivers. The recent tightening is actually a sign of improving economic prospects, and it's prudent for China to take steps designed to head off overheating and inflation.

### **Will tightening in China stall its economic growth? How will it affect other emerging markets?**

Tightening in China is intended to slow the country's rate of growth without stalling it. Because China is a major force in the economic expansion of other emerging markets, growth in those countries should lose some momentum as well, although this may not be evident for another six to nine months. In the meantime, expectations of slower growth due to recent tightening have, to some extent, been priced into the emerging equity markets. Regardless of these changes, emerging markets should continue to grow much faster than the developed world, and stock prices should continue to benefit as corporate earnings rise.

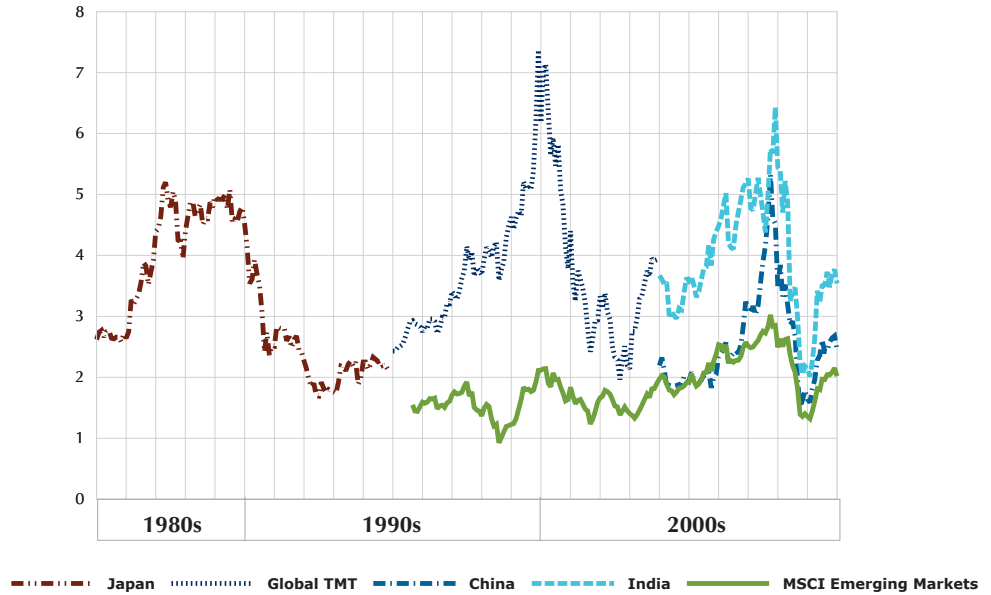
### **Are we seeing a market bubble in emerging markets?**

Not in our opinion. Stock prices often rise toward the end of a recession in expectation of a recovery, but that doesn't necessarily mean that the market is overvalued. In fact, we believe that emerging markets are currently fairly valued to slightly undervalued. With ample liquidity in the domestic and global capital markets, we expect emerging markets to remain well supported.

### **How do today's valuations compare to those of past market bubbles?**

Emerging markets stocks currently trade at 2.0x price-to-book, with an expected two-year growth rate of close to 25%—in line with their historical valuations, and still at a small discount to developed markets. This is quite different from what we observed in earlier periods that in retrospect turned out to be market bubbles. These were characterized by high valuations, with price-to-book measures in excess of 5.0x (Figure 1).

**Figure 1: Price/Book Ratios—Bubble Periods vs. Now**

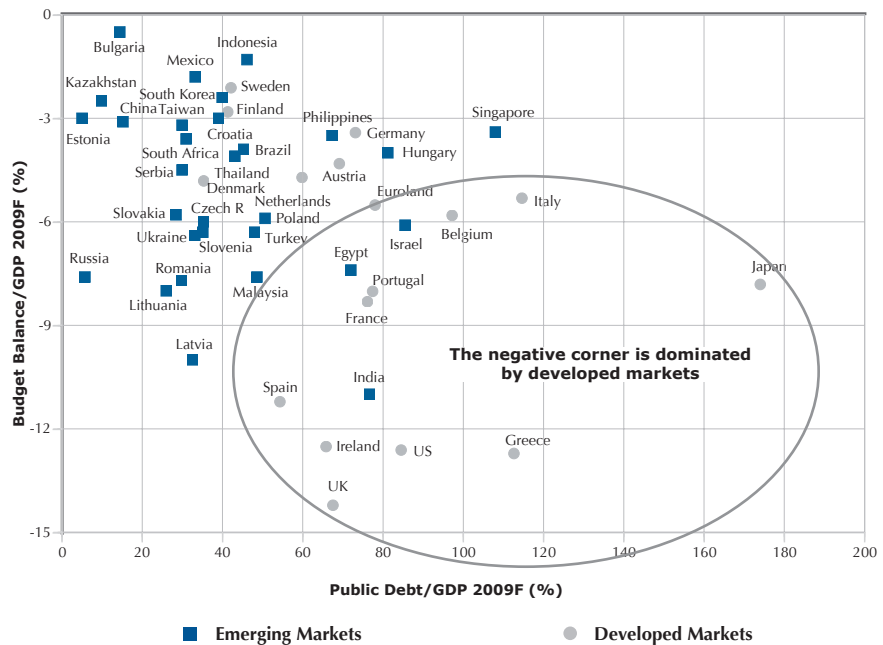


Source: Datastream, MSCI, Citi Investment Research and Analysis

**Aren't emerging markets still very risky?**

These markets are much less risky than in the past. It's true that they are still more volatile than developed markets, but it's also true that they're fundamentally stronger at the sovereign level, with better fiscal balances (Figure 2). Unlike developed countries, emerging markets have large current account surpluses, and they now control most of the world's foreign exchange reserves.

**Figure 2: Public Debt and Budget Deficit Ratios**



Source: ING, Eurostat Forecasts

We also see more strength on a corporate basis. Emerging markets companies have been delivering higher ROEs for years, with much less leverage than in the developed markets. Current estimates appear quite strong for 2010 and beyond. According to our data, earnings per share growth for emerging markets now stands at 24% over the next two years.

All of this suggests economic staying power and an increasing number of excellent long-term opportunities.

### **What are the chances of a market correction in 2010?**

We wouldn't be surprised to see some volatility in emerging markets until the global economy is on a more even course and investors recognize that we are in a growth environment. There seems to be a disconnect between what people are hearing about macroeconomic conditions and what corporations are actually delivering. Should there be a sell-off, investors would have the chance to increase their exposure to these fast-growing economies at very attractive prices. This approach has typically rewarded those investors with a longer-term focus.

### **Is this a good time to invest in emerging markets?**

From our standpoint, it's wise to have exposure to emerging markets right now. With strong fundamentals, including outstanding growth prospects, these countries are an increasingly important component of global GDP. Following a very good 2009, emerging markets are positioned to benefit over the long term from the underlying secular growth drivers—infrastructure development and strengthening local demand, for example. The correction early this year has provided an excellent opportunity to gain exposure to these markets.

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#### **Important Information**

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