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The Outlook For Emerging Markets Equities in 2008

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The returns in Canadian dollars of emerging markets equities for the five years ending September 30, 2007, have been less spectacular than in U.S. dollars, despite the strength of the Canadian dollar which this year has risen roughly 16 per cent against the U.S. dollar. Nonetheless, they have been very strong. For example, over this period, the MSCI Emerging Markets Index returned 39.1 per cent per annum in U.S. dollar terms and 26.3 per cent per annum in Canadian dollar terms.

Can emerging markets equities continue to rally in 2008? Despite ongoing write-offs by global financial institutions of mortgage-related securities, a rapid pay-down of U.S. commercial paper, continued strains in the interbank market (as evidenced by the Treasury-eurodollar spread which currently stands at roughly 150 basis points versus 53 basis points six months ago), and the increasing odds of a U.S. recession in the next 12 months, emerging markets equities have held up remarkably well. They recently reached an important milestone. For the first time since the 1997/1998 Asian crisis, they now sell at the same 12-month forward price-to-earnings ratio as developed markets. (In the early 1990s, they sold at a premium to developed markets.) Global **investors** evidently hold the view that Asia, and emerging markets in general, can, in fact, 'decouple' from a U.S. slow-down.

Cyclical Factors

The surge in emerging markets economies and equities in recent years has been driven by secular, as well as cyclical factors. Cyclical factors include fairly low nominal and real interest rates, massively (if, in the long term, temporary) favourable terms of trade shock, and the best five-year period of global economic growth ever recorded.

Secular drivers include the ongoing technology, media, and telecommunications revolution. As well, outsourcing, rising productivity (particularly in China and India), stable global inflation, and, consequently, less violent business cycles, privatization, and deregulation, and the more efficient use of capital by firms are other drivers. The result is that world trade is growing roughly one and a half times as fast as world output.

Absent a serious monetary policy mistake in China or the U.S., or adoption of protectionist measures in the U.S. and Europe, there is little reason to believe that these secular drivers will de-accelerate meaningfully in 2008 or thereafter. Emerging markets represent 30 per cent of world output at nominal exchange rates and, given global demographics, their share will grow. The key, of course, is developments in Asia and, particularly, China.

China represents 6.8 per cent of global output (greater than Brazil, Russia, and India combined) and will soon surpass Germany as the world's third largest economy. In the next five years, incredibly, it will surpass Japan as the world's second largest economy.

Slow Output Growth

The Chinese economy is growing at 11.5 per cent and, with inflationary pressures rising, the Chinese leadership would like to slow output growth to an estimated potential of 10.3 per cent. For every one per cent decline in U.S. output, growth in China is estimated to fall by 0.4 per cent.

Given the tremendous rise in domestic demand in China, which last year installed the equivalent of the entire installed electricity generation capacity of the UK, it is highly unlikely that the Chinese economy will slow sharply in 2008. Of course, a 'disturbance,' such as a large outbreak of birdflu, could change matters.

China represents not just a global supply shock, but also a demand shock. The 'triangular trade' dynamic, by which China imports commodities and semi-finished goods and re-exports to Europe (now China's largest customer), the U.S., and the rest of the world is unlikely to unravel. The appreciation of the RMB over time (think of the progress of the yen from 1960 to the present day) should set the stage for further revaluation of Asian currencies. The forward market anticipates a roughly seven per cent RMB appreciation in the next 12 months, and some analysts anticipate further gains in 2009.

Asia currently represents 55 per cent of emerging markets equities which, in turn, represents roughly 11 per cent of the world's investable capitalization. Even on an 'investable' basis, China represents the largest emerging market, roughly 16 per cent of the index. Capital outflows from China – modest in 2008, but growing thereafter – likely will support Asian equities and resource rich markets like Russia and Brazil – a country which, after a sustained period of declining inflation, is on the verge of obtaining an investment grade bond rating.

At 13.7 times 12-month forward earnings, and with earnings forecast to grow 14 per cent in 2008, emerging markets equities do not constitute a bubble, even if individual markets like China (19.6 times 12-month forward earnings) and India (21.4 times forward earnings) are fully valued by global standards. 'Global rebalancing' will be a multi-year process and investors should be positioned to benefit from the rapid changes in the world economy.

Less Robust

'Mean reversion' theory would suggest that the returns of emerging markets equities in the next five years will be less robust than the previous. But, in the long term, if growth in earnings is correlated with growth in output, then the earnings prospects for emerging markets could be deemed to be more favourable than developed markets.

Emerging markets investors should not be complacent because many political risks remain in the world. A conflict with Iran could radically alter expectations. And managing trade tensions with China and investment 'codes of conduct' with sovereign wealth funds will present substantial challenges. Still, it is hard to argue that emerging markets are not dramatically more resilient than in 1997/1998 or that a 'specialty' asset class should not be a core holding in a globally diversified portfolio. ■

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