

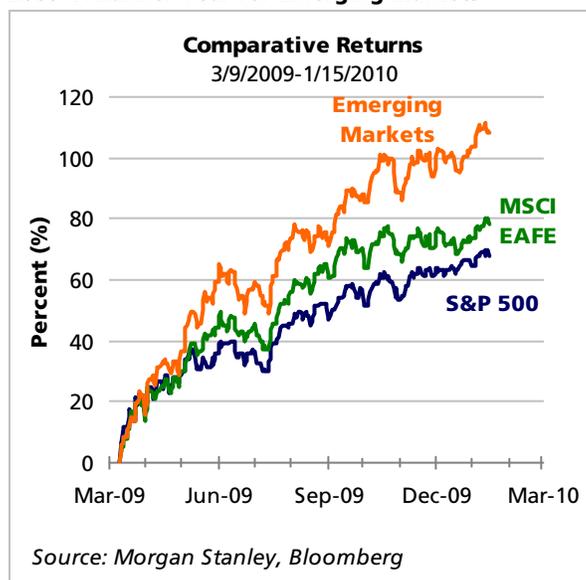
Emerging Markets: Ahead of Themselves or Still Attractive?



Martin Jansen
Senior Portfolio
Manager

Investors are conducting an intense debate regarding the continued attractiveness of the emerging markets. Since the early 2009 trough in global equity markets, emerging markets have outperformed the international developed markets by almost 29% and the S&P 500 Index by almost 42%. An outperformance of this magnitude in a mere ten months would historically have been a signal to tread more warily; many investors would be inclined to start taking profits from the emerging space and redeploy the proceeds in the more stable developed markets. Are emerging markets ahead of themselves? Or is the past ten months the first phase of a more durable outperformance trend?

2009: A Banner Year for Emerging Markets



To answer these questions we must first understand the key drivers for this sterling performance. After holding up well in the first phase of the recent crisis, emerging markets collapsed when commodity and energy prices fell sharply between May and October 2008. This was exacerbated by the simultaneous unwinding of the huge yen/emerging market equity carry trade, as developed market players frantically deleveraged and took profits to plug the escalating shortfalls and cash outflows in their portfolios. The emerging economy paradigm took a huge credibility

hit in the process. This tornado abated as commodity prices stabilized around October 2008, and emerging markets actually bottomed well ahead of their developed peers.

While economic growth in the emerging economies did take a knock, by early 2009 it was evident that most of the major emerging economies were weathering the recession much better than expected. In fact, emerging economies were in better shape on average than their developed peers, with relatively contained budget deficits, high levels of foreign exchange and current accounts well under control. In aggregate, strong corporate balance sheets and low levels of sovereign debt were additional indicators that the risk premiums demanded of emerging markets were extreme. These factors, in addition to recovering exports and rising commodity and energy prices, set the stage for the superior performance in 2009.

Rather than making a hasty decision based on relative momentum in 2009, the emerging market call should be contingent on the valuation of emerging markets in a global context and incorporate some evaluation of their relative growth prospects moving forward. The relative earnings outlook is somewhat muddied by the huge write-offs of 2008–09. Consequently, it is preferable to use 2010 earnings forecasts as a starting point, as these should provide a more stable and apples-to-apples valuation framework. On this basis, as shown in the accompanying table, emerging markets are about 10% cheaper than the global average on price/earnings, a little more expensive using price/book and significantly more expensive on price/cash flow.

Emerging Markets: Valuation in a Global Context

Index	2010 (e) P/E Ratio	Price/ Book Ratio	Price/ Cash Flow Ratio
MSCI World Index	15.2	1.8	6.4
S&P 500 Index	15.0	2.3	8.2
MSCI Global ex-U.S.	15.4	1.7	5.4
MSCI Emerging Markets	13.6	2.2	10.2

Source: Bloomberg as of 01/08/10

These valuation factors in aggregate indicate an asset class more or less in line with the global average. By historical standards, this is rich. In the past, valuation discounts of 40% at the bottom of a cycle indicated an attractive entry point into the emerging markets, while a 10% discount signaled that it was time to start exiting from them. This is essentially the argument the bears are using to reduce exposure to the asset class.

This analysis would typically coincide with an imminent peak in the global profit cycle; if that were to be the case, the bears would have a point. In the current context, however, that would necessarily imply a "double dip" global recession. Given our base case that the developed economies will continue to expand into 2011, albeit hamstrung by high unemployment and modest consumption growth, this fear would seem to be overstated.

This does, however, impact the earnings growth potential for developed markets beyond 2010, which will be a year of recovery growth. The structural headwinds are likely to keep earnings growth

contained to single figures. Increasing consumerism, strong and rising commodity prices (for beneficiaries such as Brazil) and sustained high levels of capital investment activity would, on the other hand, suggest that earnings growth in the emerging markets group could be well into double-digit territory in the coming years. Under this scenario, the discounts applied to emerging markets may no longer be appropriate. In a world where earnings growth is scarce, emerging markets are one of the few reliable sources of it, along with commodity and energy producers and developed companies deriving a material part of their revenues from emerging economies.

In conclusion, it would seem premature to abandon the emerging market theme now. If valuations were to become stretched (arguably around a 20% premium versus developed markets), one could make the case for cautiousness. And while this may happen in the course of 2010, emerging markets appear to be well placed to generate superior returns for the time being. ■

Copyright © 2009 ING Investment Management. This material may not be reproduced in whole or in part in any form whatsoever without the prior written permission of ING Investment Management. To obtain permission, contact stephen.easton@inginvestment.com or 860-275-2110. For all other inquiries contact David White, Publishing Manager, david.white@inginvestment.com or 860-275-2056.

This report does not make any recommendation about your investments, and this information should not be considered investment advice. Any opinions expressed herein reflect our judgment at this date and are subject to change. Certain of the statements contained herein are statements of future expectations and other forward-looking statements that are based on management's current views and assumptions and involve known and unknown risks and uncertainties that could cause actual results, performance or events to differ materially from those expressed or implied in such statements. Actual results, performance or events may differ materially from those in such statements due to, without limitation, (1) general economic conditions, (2) performance of financial markets, (3) interest rate levels and (4) increasing levels of loan defaults (5) general competitive factors (6) changes in laws and regulations (7) changes in the policies of governments and/or regulatory authorities. ING Investment Management assumes no obligation to update any forward-looking information contained in this document. Past performance is not indicative of future results.