



The Changing Face of Emerging Markets

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Overshadowed by strong U.S. stock market performance in the late 1990s, emerging markets are once again taking center stage. With China acting as the world's economic growth engine, and 10 emerging market nations joining the European Union, the relevance and importance of the emerging market asset class can not be ignored. In this article, AIM international portfolio managers, Steve Cao and Borge Endresen review both regional trends and important changes to the asset class including improved accounting standards/greater transparencies, rising industrial productivity, lower interest rates and valuations near 30-year lows.

Asia emerges as world's growth engine

Economic growth in emerging Asia continues to exceed expectations. According to the International Monetary Fund (IMF) from mid-2003 to the first quarter of 2004, the region's growth rate averaged more than 10%. Without a doubt, China is both the region's and the world's economic growth leader. To illustrate how far China has come as a world economic/trade factor, consider the statistics in the table below. From 1997 to 2003, China's GDP per capita has risen more than 60%, while its exports have more than doubled.

China: Growth and exports

	1997	2000	2003
GDP per capita	\$730.8	\$852.6	\$1,132
Exports (billions)	207.3	279.6	485

Sources: National Bureau of Statistics, People's Bank of China, CSFB

Beyond China, emerging Asia has indeed evolved, overcoming some significant obstacles. The 1997-1998 financial crisis produced severe currency and equity market downturns, yet the region emerged stronger.

"Most emerging market currencies now freely float," explains Cao. "While currencies will still fluctuate; a boom/bust scenario is now not very likely. Other important factors in the Asian financial crisis were overinvestment in property and commodities. Today, governments and businesses are much more cautious in terms of investing their cash flows."

Indeed, emerging Asia is moving forward and there is speculation that both Taiwan and South Korea could be upgraded to developed market status in the future. Taiwan,

especially has witnessed strong growth trends and has increased its current account balance (as % of GDP) from 1.3% in 1998 to 10.2% in 2003. (Of note: Taiwan, South Korea and China all have investment grade long-term sovereign debt ratings. In many cases, government entities still own or control many companies so these nations' equity markets have not yet caught up to their investment-grade debt servicing history.)

Emerging Europe joins EU

Many investors equate Europe to a few developed nations, particularly France and Germany. However, on May 1, 2004, the EU expanded to 25 nations, the 10 new members all being emerging market nations. New EU member nations include: Cyprus, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia and Slovenia.

As you can see in the box below, the new 25-country EU, has a population size larger than that of the U.S. Also, given the addition of the new members (many of which were growing faster than the former 15-member EU), gross domestic product for the 25-country EU is expected to increase by 5%.

	EU-15	EU-25	U.S.
Population (in millions) ¹	380.8	454.9	291.4
GDP (% of world's) ²	26.8	28.1	32.5

Sources: ECB, Eurostat, IMF, BIS, World Federation of Exchanges, US Federal Reserve. ¹Jan. 2004 ²GDP based on country GDP in current US dollars

Of importance to investors, candidate countries must enact reforms/legislation to bring them in line with common EU laws long before they are “admitted” into the EU and begin a transition process from a planned to a market economy. For many nations, this process actually began immediately after the fall of the Soviet Union.

“During this process,” explains Endresen, “candidate countries established new institutional/legal frameworks, opened up their economies to international trade and capital flows and reorganized their production structures.”

Latin America

High commodity prices, strong export demand and low (for the region) interest rates have bolstered recent Latin American returns. However, Latin America, particularly Brazil, is heavily weighted in commodities. The eventual peak in commodity prices will therefore have an impact on the region. Domestic demand, however, is also picking up across the region, particularly in Mexico.

Perhaps best known to investors for its wildly fluctuating currencies and seeming dependence on IMF assistance, Latin American economies are making progress. Trade account balances are improving and punishing inflation, which once hovered around 20%, has fallen considerably. Additionally, Mexico—whose largest trade partner is the U.S.—continues to be the beneficiary of U.S. growth trends.

The case for emerging markets

As discussed earlier, emerging markets are witnessing tremendous economic growth. In fact, as the table below illustrates, over the five-year period since the Asian financial crisis, emerging market stocks have significantly outperformed their developed market peers. In this section, we explore the fundamental improvements and changing economic conditions that are helping drive these returns

Emerging markets vs. developed markets (5-year returns ended September 30, 2004)

MSCI Emerging Market Free Index	6.04%
MSCI EAFE Index	-0.85%
S&P 500 Index	-1.31%

Source: Lipper, Inc.

Improved accounting standards/greater transparencies: Many investors continue to share the misperception that emerging market companies provide little accounting disclosure. In fact, however, many emerging Asian and eastern European companies have or are moving toward adopting international accounting standards.

“In eastern Europe, we only invest in those which are up to international accounting standards,” says Endresen. “This allows investors to get a true insight into a company as transparency is the key to comparability of stocks.”

Emerging Asian companies are also disclosing more ...and more often. “Companies now typically report quarterly as opposed to semiannually,” says Cao. “And more companies are using mark-to-market accounting for securities portfolios. Also, many banks and conglomerates are placing stricter restrictions on non-performing loans.”

Trade surplus/falling interest rates: As discussed earlier in this piece, during 1997-98 (Asian financial crisis) many emerging market economies witnessed high levels of indebtedness and the trade balance for the asset class as a whole swung to a nearly \$80 billion deficit. Today, however, reflects a total reversal of that trend with the asset class now running close to an \$80 billion surplus.

With improvement in the trade balance, emerging markets have also witnessed a dramatic decline in short-term interest rates. For many emerging nations, that means interest rates have dropped well into the single-digit range.

Rising productivity levels: Driven by outsourcing and globalization, a productivity boom has rolled through many emerging economies. According to Cao, “It should come as no surprise that China is leading the productivity boom given its industrial capabilities and its enormous rural labor pool.” Indeed, as other nations begin to feel competitive pressure from China, they in turn begin outsourcing to China.

“Eastern/central Europe boasts an extensive labor pool with low-cost production centers. These factors have already encouraged companies in other parts of the world to select work sites in eastern Europe.” explains Endresen. “We also continue to see large foreign direct investment into eastern/central Europe.”

Population demographics: As productivity continues to rise in emerging market economies, there will be no shortage of labor—approximately 85% of the world’s population resides in emerging market nations. This should come as no surprise, when you consider that China and India both sport populations well in excess of one billion people.

Improved fundamentals yet low valuations: Given all the improvements to fundamentals, emerging market stocks continue to be very undervalued. As you can see from the table below, emerging market stocks continue to trade at a significant discount to North American stocks.

Despite fundamentals, emerging market stocks continue to trade at a discount

	EM	N. America
Price/Earnings	12.6	18.3
Price/Book	1.8	2.8
Price/Cash Earnings	7.3	11.8
Dividend Yield	3.0	1.8

As of August 31, 2004. Source: MSCI. Valuations based on trailing 12-month reported financials.

Beyond comparisons with other markets, the asset class is near its own 30-year price/earnings low, which is 10.8. Another interesting point is that the current EM dividend yield is nearly one-third higher than its 30-year average of 2.3. Says Cao, “The increased dividend payout to shareholders is a good reflection of the improved corporate governance of the asset class.”

Low correlations: Another compelling argument for the asset class is its low correlation to other asset classes. As the table below demonstrates, developed international markets (EAFE) do not move in lock step with U.S. markets (S&P 500). Emerging markets offer an even lower correlation to U.S. markets than their developed market peers.

10-year Correlation Matrix

10/94-9/04

U.S. stocks (S&P 500 Index)	1.00
Int'l Developed stocks (MSCI EAFE Index)	0.78
Emerging Market Stocks (MSCI Emerging Markets Index)	0.68

Source: Zephyr

On the horizon

Exceptional economic growth rates combined with improvements in accounting standards and rising productivity emphasize the great strides the asset class has made over the last several years. Emerging market returns for the last five-year period, were positive, while U.S. and developed international markets turned in negative results.

With supportive demographics (young populations, growing quickly), high savings rates and rising GDP per capita, emerging markets offer investors a world of opportunity beyond U.S. shores. And these factors combined with low stock valuations make a compelling argument for the asset class.

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Investing in emerging markets involves greater risk and potential reward than investing in more established markets.

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