

The return of capital flows

Expectation from emerging markets should moderate in 2010 compared to the previous year, but the asset class is very likely to outperform, predicts **Stefen Hofer**.

Emerging market equities are set to deliver over 50 per cent performance in 2009, more than double the returns of mature markets. Indian equities top the list at 80 per cent. South Africa's 20 per cent is the lowest among the major emerging markets, but still a respectable outcome. Heading into 2010, investors should consider how the landscape may change and what this means for potential returns in the emerging markets. In sum, our assessment is that while expectations should moderate, the backdrop for the asset class will likely be very conducive to outperformance. It should be another good year.

First and foremost, the return of capital flows will likely be the dominant factor supporting emerging markets. Second, favourable comparisons with developed world growth and fiscal positions will continue to be a focus. The growing role of domestic demand and the associated decoupling theme appear to be a structural, not cyclical, phenomenon. And last, the advent of key elections will likely reintroduce politics-driven volatility over the shorter term.

Given the employment backdrop in the US and the developed world, we believe

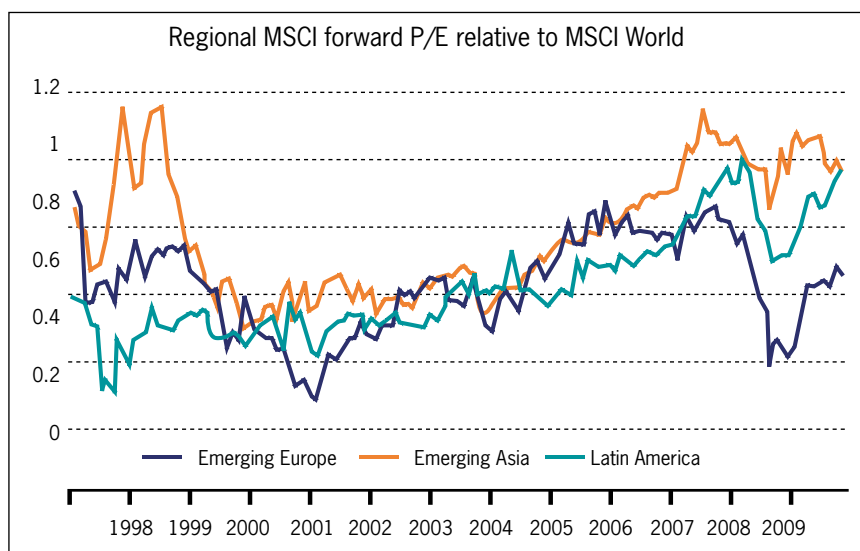
that G3 interest rates will remain at or near record low levels for 2010. Further, the gradual and orderly withdrawal of quantitative easing measures is only likely once central bankers feel confident that prevailing real economy conditions are strong enough. For emerging markets, this means that the carry trade environment that has been so supportive of risky assets in recent months is likely to stay in place. In 2009, the risk rally helped lift most, if not all, boats. Even if markets pay closer attention to country-specific issues in 2010, the liquidity impulse being generated in the developed world is such that a substantially greater differentiation by investors may not materialise.

Turning to politics, the headline event in 2010 will be Brazil's general elections, scheduled for October. While this may not be a focus today, given Brazil's large weight in both equity and fixed income benchmarks, the election will likely dominate emerging markets for much of next year. Investors have been in the enviable position of not having to worry too much about Brazilian politics since Lula da Silva first took presidential office in 2003. And even though our base case



scenario is that the market-friendly and successful policy framework will remain intact following the race, an increase in Brazilian asset price volatility looks almost certain. Higher volatility for other emerging markets on the back of the Brazilian election appears likely as well.

Are investors paying too much for emerging market stocks? Trading at a moderate discount to the MSCI World, emerging market valuations are not especially compelling. To be fair, this has been an off-heard criticism of emerging equity markets throughout the risk rally of 2009, yet narrowing valuation discounts have done little to impede further performance. Prudent investors should take note of the low spread levels of emerging market bonds to US Treasuries, however, which have already returned to pre-Lehman-Brothers levels. As a proxy for country risk, markets seem to be pricing a fairly generous scenario given that 2010 is an important election year. In other words, valuations pose some downside risk, all else being equal, but given emerging markets' growth leadership and earnings momentum, a major downward re-rating should be easily avoided.



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