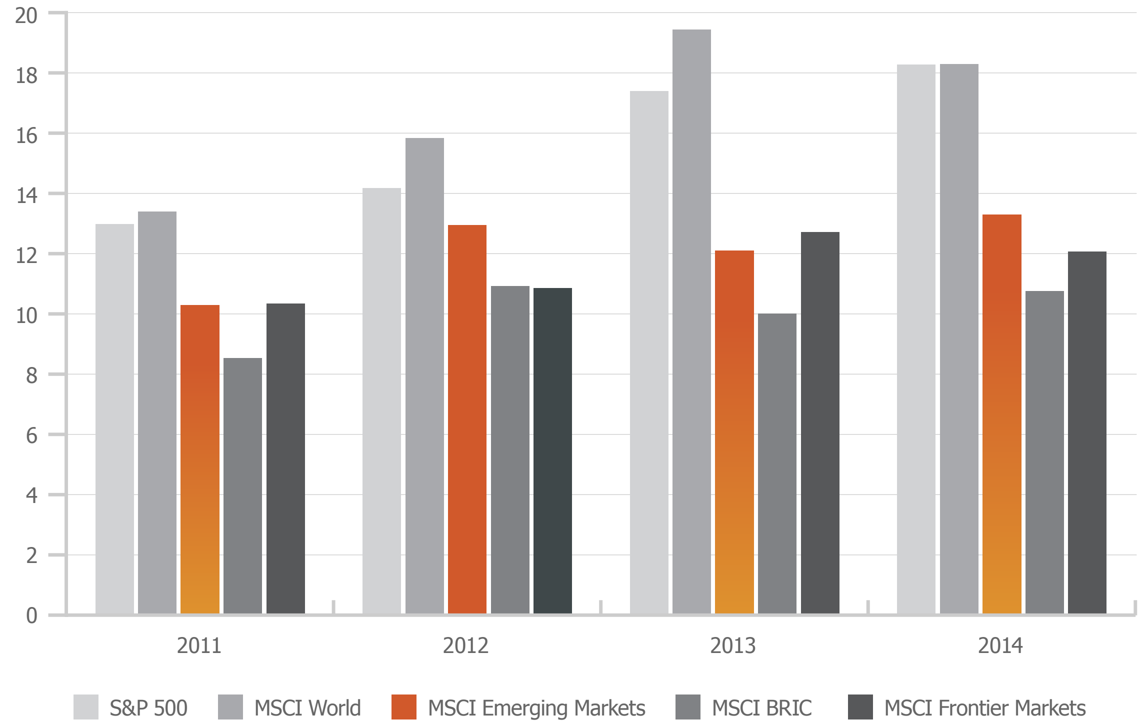
Time to Invest in Emerging Markets

Emerging Markets Report | 2014

HUGE OPPORTUNITIES IN DIRT CHEAP EMERGING MARKETS

With the S&P500 making new all-time highs and with valuations nearing expensive levels, one marvels at just how cheap the emerging markets are. With the S&P500 trading at an 18 price to earnings multiple it is 63% more expensive than the MSCI BRIC index with a 11 P/E. With the MSCI Emerging Markets Index trading at a trailing P/E of 13, it is some 19% below its 18-year average of 16 – with its discount relative to the S&P500 near 8-year highs. Most emerging market equities are currently valued below their historical average.

P/E COMPARISONS

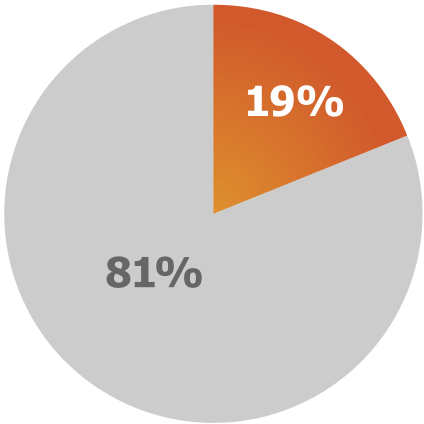


Source: Bloomberg

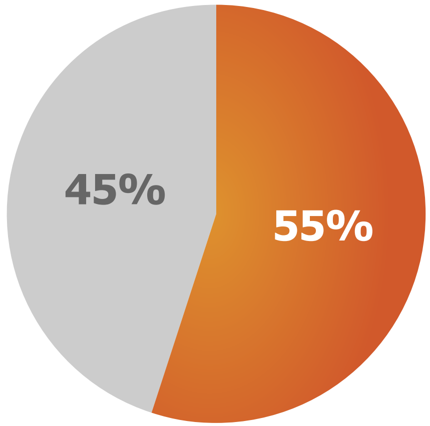
"Most emerging market equities are currently valued below their historical average."

Historically the attractiveness of the emerging markets has been that they offered high returns and are a source of diversification. With valuations so low, particularly compared to the developed markets, opportunities abound particularly when seen in the context of their significant growth potential. The IMF has estimated that over the next 10 years 70% of global GDP growth will come from the emerging markets and 40% of that growth will come from China and India. Not to mention the fact that for the first time in history, the emerging markets collectively make up the majority of the planet's economy at 51% of global GDP. Yet emerging market stock markets account for roughly just 10% of the world's stock market capitalization.

GDP World Share in 1990



GDP World Share in 2020 (Forecast)



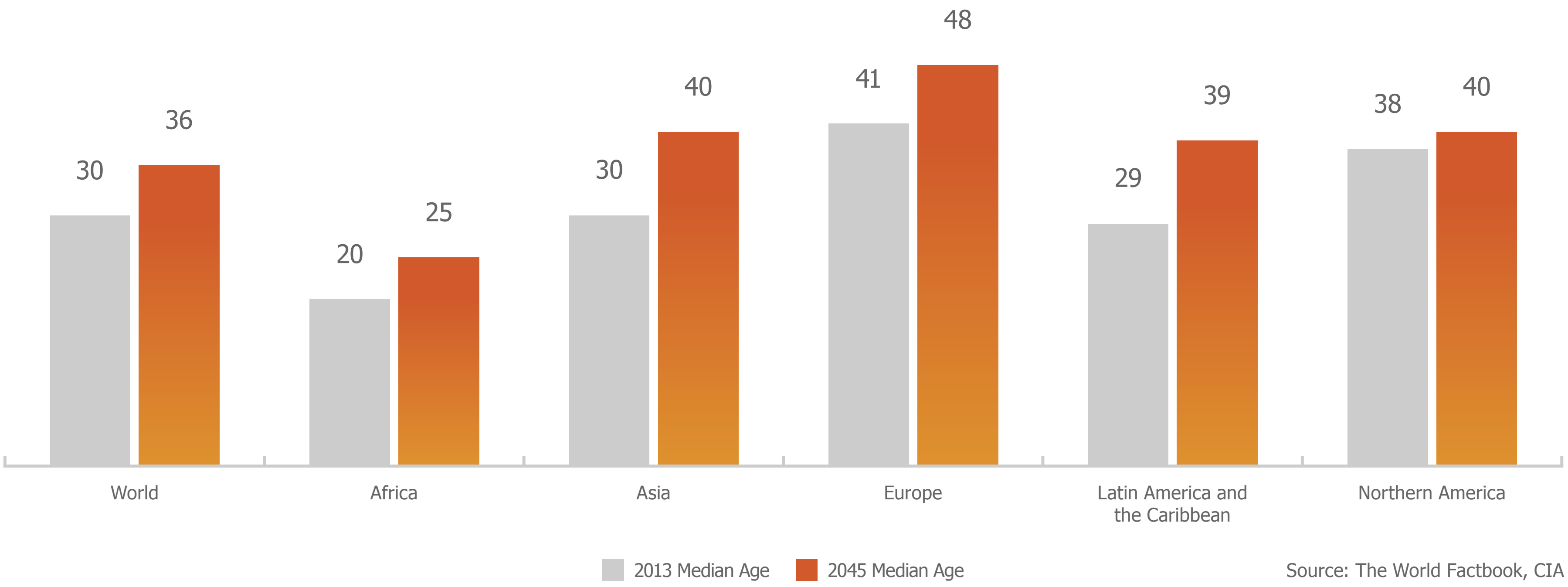
Developed Markets   Emerging Markets

Not only have emerging markets economies been growing at a faster rate than developed markets, but they have done so in a fiscally more responsible manner. The average debt to GDP in emerging markets is 35% compared to 70% in the G7. Also the demographics of your typical emerging market is quite promising considering the average age in the emerging markets is 30 compared to 40 in the developed world. Today the emerging markets are fiscally sound and offer growth potential with finer future prospects than the developed markets.

For example, the BRIC countries make up 22% of the world's GDP, yet they have only 5% of the world's government debt. With an ever increasing middle class, sound balance sheets, high international reserves and savings - emerging markets are on a strong fiscal footing.

The emerging markets have growing populations which are more consumer oriented, becoming urbanized and buying cars. In the US, consumerism makes up 70% whereas in China it's approximately 11% of the economy. There are roughly 60 mn people a year entering the Chinese and Indian middle class – that's about the population of Italy. Coca-Cola Co., relies on more than 60% of its business coming from the emerging markets. KFC, with almost 4,300 outlets in China alone, will soon have more restaurants there than in the US.

THE AGING OF THE WORLD'S POPULATION



Source: The World Factbook, CIA

Whereas many developed markets have aging populations, emerging and frontier countries have young ones. In Japan and Germany the median age is 45, comparatively old when likened to Iraq with half of their population under the age of 25. Africa and Asia have median ages of 20 and 30 respectively compared to developed markets in general with median ages of 41. Demographics drive economies, since young populations tend to produce and consume more, whereas older populations consume less and are often a strain on national pension and health care budgets.

CHINA - THE GLOBAL POWERHOUSE

When China cynics talk China they invariably forecast impending credit and real estate bubbles. However, China on a forward basis is trading at a 7 P/E with an economy growing at an average 7.5% annualized growth rate. The economy has made such strides that it's forecast by the OECD to possibly overtake the US as the world's largest economy by as early as next year. Considering China's recent under performance and its historically low valuations we believe the market offers major upside. Driving growth in China will be its emerging middle class. In 2014 the Chinese are at a pace to buy a record 20 mn cars, a 10% surge from 2013 extending its lead as the world's biggest car market. China trades at a significant discount not only to the MSCI Emerging Markets Index but to its 10-year average as well. The MSCI China Index has a P/E of 9.5 compared to 10-year average of 14.4. This is the second-largest discount behind Russia. A transition to consumer-led growth could bring overall GDP growth rates down to a more sustainable 5% - 7% range, lower than last decade's hefty 10% rate.

THE SHANGHAI COMPOSITE INDEX MAY BE BOTTOMING

The risk-to-reward trade off looks extremely attractive, considering the Shanghai Composite Index is trading at roughly 65% below its 2007 high. China's personal savings is a staggering US$ 7.5 tn - at a new high and over 15 times greater than US levels. With governmental policies discouraging active speculation in local real estate, we believe this pool of excess liquidity will soon find its way into the local equity markets.

We believe it's challenging to time markets. Owning inexpensive assets with significant growth potential long term is the way to go. Maintaining a portfolio of emerging markets stocks allows maximum diversification benefits and gives investors access to the world's fastest growing economies. FMG is dedicated to affording investors efficient and multiple ways to gaining exposure to these markets. Due to compelling valuations and attractive growth prospects we highly recommend being overweight emerging markets at this time.

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