

**SECULAR GROWTH IN EMERGING MARKETS AND HOW TO ACCESS IT**

Scott Berg, Portfolio Manager Global Equity Strategy, T.Rowe Price

T.Rowe Price

---

*Despite strong corporate earnings and improving sovereign balance sheets, in 2008 emerging markets delivered their worst performance in modern history. Nevertheless, emerging markets are likely to continue to drive global growth. This research paper identifies both the secular trends found in stronger emerging markets and the weaker markets to avoid. Given differing investor risk tolerances, the paper also addresses how to access this secular growth via direct or indirect investment in emerging markets. Finally, it presents data showing that the turbulence of the past year has created an appropriate environment for investors to adopt a less constrained approach to global equities investing.*

During 2008, investors witnessed the most severe correction in emerging market equity history, amid levels of market volatility and uncertainty that were truly exceptional. As 2008 unfolded, events naturally provoked the question of whether the fundamental case for emerging markets had been weakened. Following an 88% rally in the MSCI Emerging Market Index from its trough on 27 October 2008 to the date of this paper, 28 July 2009, the market has at least expressed the sentiment that the asset class maintains temporary investment appeal<sup>1</sup>. Putting to one side the immense market swings seen, are the secular growth trends that underpinned such significant emerging market outperformance between 1998 and 2008 still apparent? And can the case still be made that exposure to emerging markets is fundamental to the strong long-term performance of a global equity portfolio?

Integral to the discussion on the case for emerging market investing is the consideration of the most appropriate route for accessing any prospective benefits. With global economies and markets more intertwined than ever, it is clearly not necessary to have a direct allocation to emerging markets in order to gain exposure to prospective benefits, assuming that an investor's opportunity set in the developed world is broad. Any detailed analysis of a company's prospective earnings and, hence, the potential stock return should encompass whether direct or indirect exposure to emerging markets forms part of a company's future earnings stream. Developed and emerging markets are inexorably linked, and many companies facing the challenge of maintaining earnings growth have long since targeted the growth of operations outside of the developed world. From luxury brands tapping into Asia's and South America's growing consumerism<sup>2</sup> to the world's major pharmaceutical companies positioning to be part of China's health care plan<sup>3</sup>, indirect access to trends in emerging markets continues to provide significant earnings growth potential if companies execute their intentions successfully.

---

<sup>1</sup> MSCI Barra, in USD

<sup>2</sup> Reuters, 20 January 2009

<sup>3</sup> Reuters, 22 July 2009

## Due Diligence Forum Research Paper

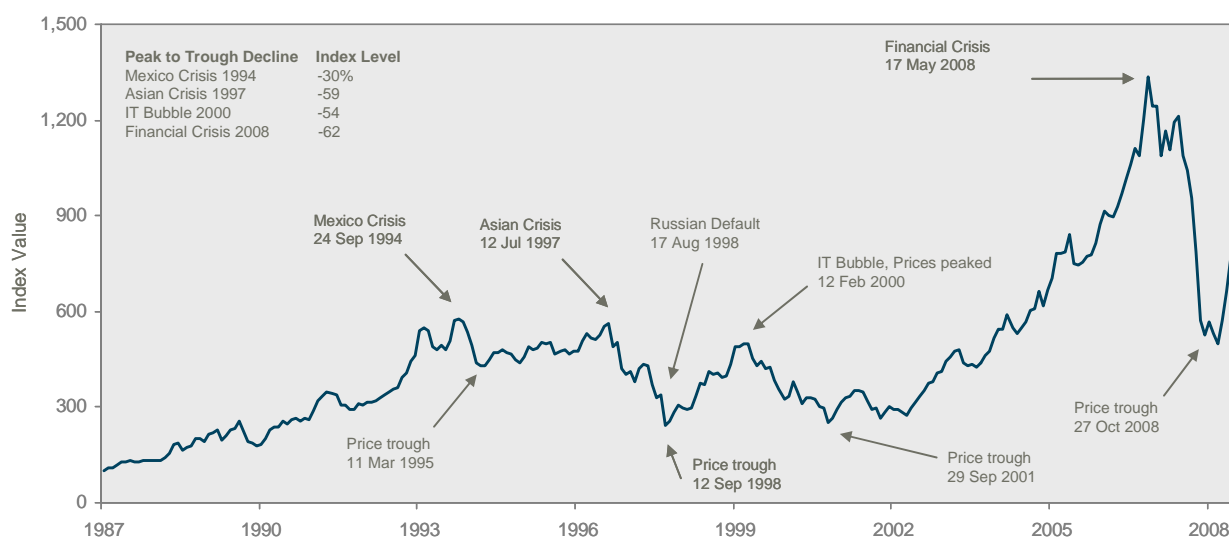
Without constraints upon an individual's ability to implement exposure to emerging markets, the question of whether to adopt an indirect or direct approach relates to risk and reward outcomes in isolation, as well as part of a wider portfolio.

With respect to the balance of exposure, to maximize returns inevitably incorporates a large measure of timing. Sentiment and the risk tolerance of the broad market will affect listed emerging market companies differently than developed companies with emerging market operations. The timing decision of when to skew a portfolio towards direct or indirect exposure is arguably a harder discipline than understanding the long-term trends and prospective benefits attached to the asset class, and success is not formulaic. Therefore, this paper concentrates on the long-term benefits of accessing emerging markets and proposes that both direct and indirect exposure within a global equity portfolio will be beneficial with respect to returns.

### ONCE IN A GENERATION EQUITY SELL OFF

The year 2008 marked a phenomenally disappointing period for emerging market equity returns, as shown in Figure 1 below.

Figure 1: Long-term performance of emerging markets – December 1987 to June 2009



Source: MSCI Barra, Morgan Stanley Research. USD

While there were events earlier in 2008 (such as the Russian/Georgian conflict) which precipitated weakness in individual countries, it was the failure of Lehman Brothers in September 2008 that sparked a broad-based equity slump, the worst since the 1930s<sup>4</sup>. Specifically, the Lehman failure drove a widespread collapse of investors' appetite for risk-bearing assets which, together with rapid

<sup>4</sup> ICMA-RC, December 2008

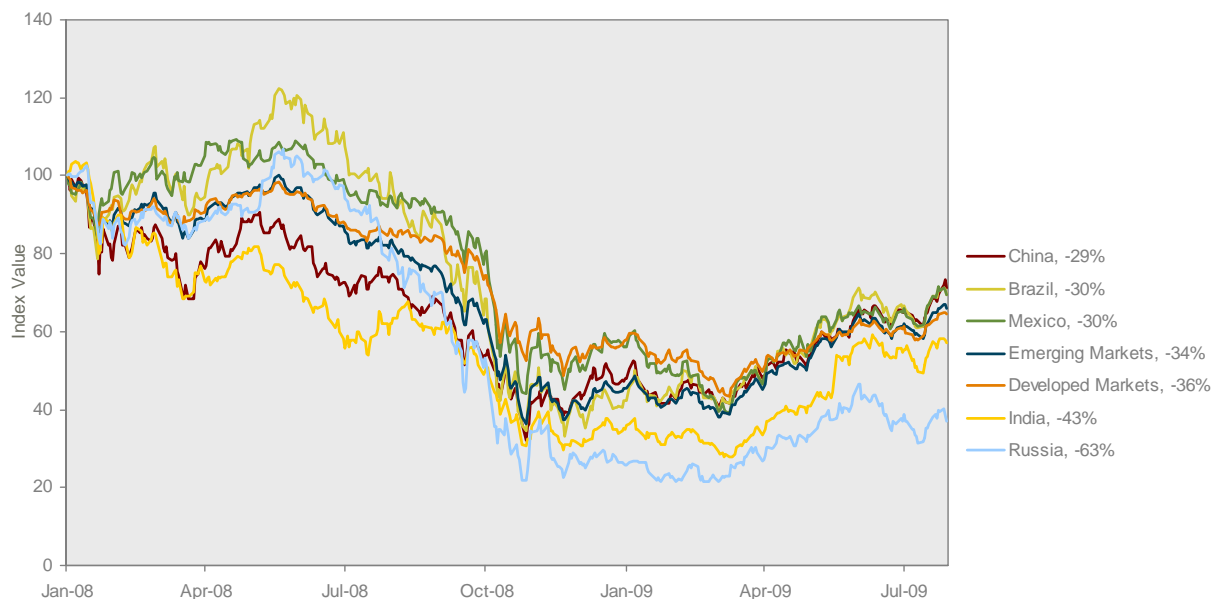
## Due Diligence Forum Research Paper

deleveraging, created a perfect storm for emerging market equities, leading to significant underperformance relative to developed markets.

The emerging market sell-off was brutally indiscriminate, affecting not only countries with structural imbalances (such as high current-account deficits, most visible in Eastern Europe) that required intervention from the International Monetary Fund, but also stronger, more diversified economies that were arguably better placed than the developed world to withstand a global economic crisis.

Alongside the move away from risk assets, falling commodity prices magnified the selling pressure on emerging countries seen as particularly reliant on commodity-derived revenues. Chart 2 demonstrates the magnitude of the market impact on Russia and Brazil. With energy and materials composing around 76% and 57%, respectively, of their MSCI All Country World Index<sup>5</sup> exposure, the bursting of the commodity bubble represented a significant economic event.

**Figure 2: Performance of emerging market countries – January 2008 to July 2009**



Source: MSCI Barra. USD

Looking back on the financial crisis that afflicted the global economy in 2008, emerging markets equities suffered disproportionately as risk aversion rose. Indeed, between 30 April 2008 (when the VIX sat at 20) to when the VIX topped 80 on 27 October 2008<sup>6</sup>, the MSCI EM Index underperformed the MSCI World Index by just under 20%<sup>7</sup>. This highlights a risk that is integral to the asset class, namely that in times of turmoil investor sentiment will play an enhanced role in market returns.

<sup>5</sup> MSCI Barra

<sup>6</sup> Bloomberg

<sup>7</sup> In USD

## Due Diligence Forum Research Paper

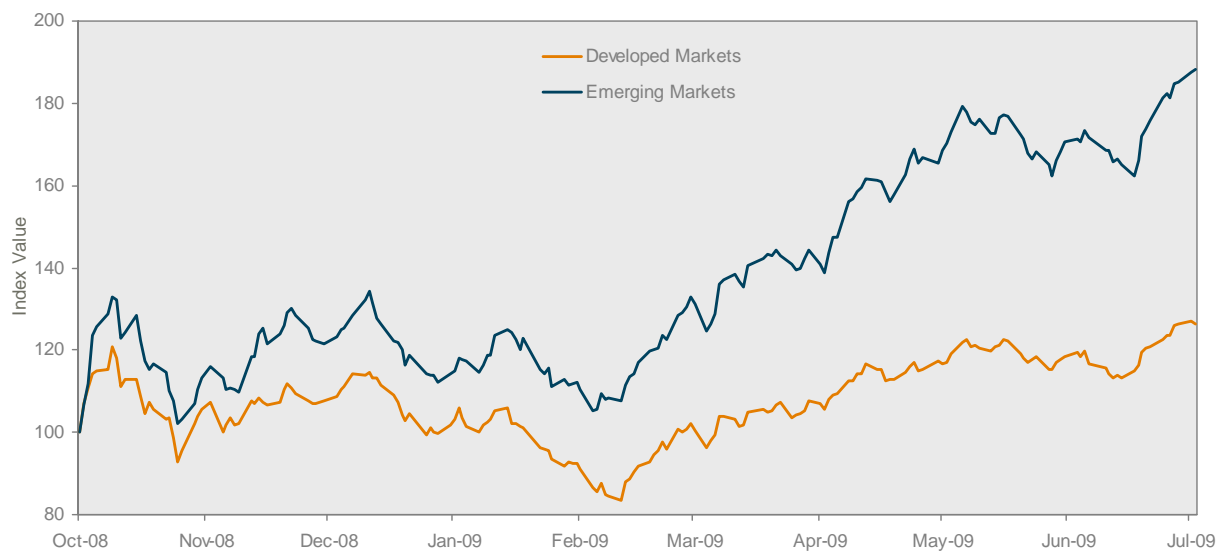
While a de-rating may be appropriate for an asset facing income suppressing influences, it is important to note that the origin of this particular sell-off lay outside the emerging world. Indeed, when looking at one of the catalysts of the global market crisis in 2008 – excess leverage – in comparison to developed markets, emerging nations in aggregate had a smaller credit bubble (in part, because banking penetration remains in its relative infancy<sup>8</sup>) and hence significantly less leverage at the consumer level. The relative strength of the emerging world’s balance sheets will be discussed in more detail, but these factors were largely ignored as the global financial system was stretched to its limits and risk aversion became a dominant force.

Inevitably, periods of turmoil do create opportunity, however, and this has been reflected within global equities as a whole, but nowhere more so than in the emerging market world.

### WHY HAVE EMERGING MARKETS RECOVERED SO STRONGLY?

Since emerging market equities bottomed in late October 2008, there has been an encouraging rebound in market levels on both an absolute and relative basis as shown in Figure 3.

Figure 3: Emerging and developed market performance – 27 October 2008 to 29 July 2009



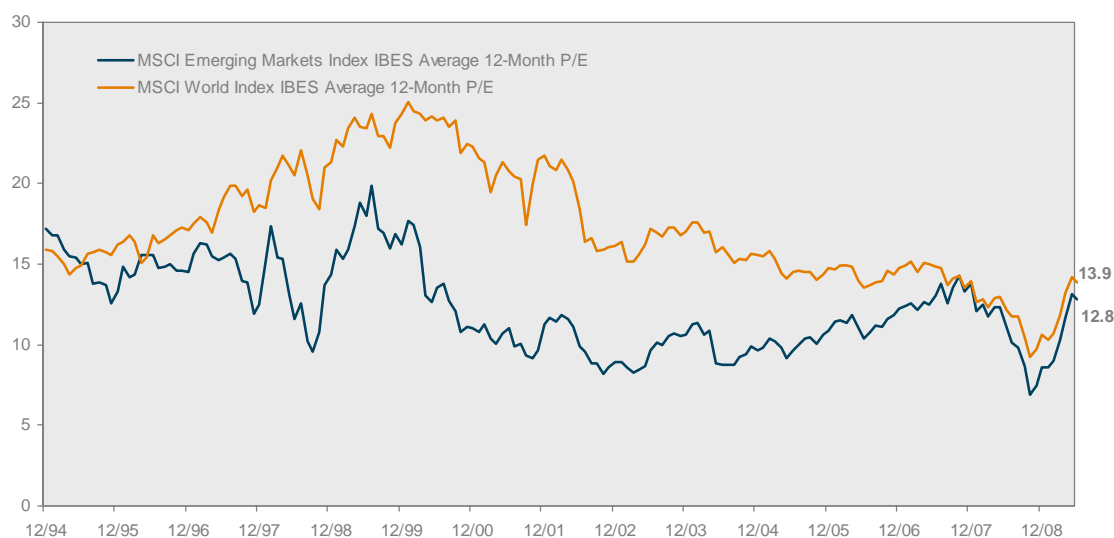
Source: MSCI Barra

Although economic uncertainty persists, the outperformance versus developed markets is likely to have been fuelled by many of the factors elaborated on later in this paper. When such factors dovetail with extremely low valuations (Figure 4, showing asset class P/E multiple falling to its low since the index series began in 1994), it produces a compelling entry point for many investors, particularly as broad market risk appetites improve<sup>9</sup>.

<sup>8</sup> IMF IFS, Central Bank Data, Merrill Lynch estimates

<sup>9</sup> UBS

Figure 4: Emerging vs. developed markets relative valuations – Dec 1994 to June 2009



Source: MSCI Barra, Factset. 12 to 24 months forward consensus

Stepping outside of volatile sentiment factors, this paper proposes that the recovery seen in emerging market valuations is partly due to the recognition that, in the near-term, GDP growth in many emerging countries will remain attractive when compared with the developed world. In short, in a world that is challenged from a near-term growth perspective, the IMF forecasts that GDP will grow by 1.6% and 4.7% in emerging markets in 2009 and 2010, respectively<sup>10</sup>. It adds that, structurally, emerging markets are now better placed to deal with harder economic times than in previous crises; a point elaborated upon later.

The positive momentum seen since emerging markets bottomed in October 2008 has also been magnified by the monetary and fiscal policy responses taken by emerging market governments and the IMF to prevent the crisis from deepening. Examples include Russia, which in response to the crisis of 2008, launched a rescue package equivalent to 9% of GDP. Separately, China announced a \$US585 billion stimulus package that is driving its economy towards an estimated 8% GDP growth in 2009<sup>11</sup>. These actions have so far prevented major defaults, currency devaluations (in contrast to the experience of both Russia in 1998 and Mexico in 1994) and further contagion in investor sentiment. For now, it appears as though a developed world crisis has not translated into an even larger crisis in the emerging world.

<sup>10</sup> IMF, World Economic Outlook Update, July 2009

<sup>11</sup> Bloomberg

## THE FUNDAMENTAL CASE FOR EMERGING MARKETS STILL HOLDS

Despite a partial recovery in global equity markets, economic conditions remain extremely challenging, while the longer-term consequences of the global recession remain uncertain. Amongst numerous data points that can be highlighted, unemployment in the Euro zone and the US is approaching 10% (both ten year highs<sup>12</sup>) while the UK and US governments will need to address enormous 2009 fiscal deficits estimated to be -11.6% and -13.6%, respectively<sup>13</sup>.

Beyond the near-term challenges, there are tangible signs that we are in the midst of a period of change, with Figure demonstrating a broad framework of this transition.

Figure 5: The changing economic landscape

	Old Norm	Transition Period	New Norm
<b>Global Real GDP</b>	>5%	0% to negative	2% to 3%
<b>Inflation</b>	Modest 3% but rising	Spike then collapse	Deflation/Inflation?
<b>Pricing Power</b>	Strong	Disappeared	Return slowly
<b>Profit Margins</b>	Continuously improving	Free fall	Improving
<b>Real Interest Rates</b>	At 0%	Rising	Resetting higher
<b>ROEs</b>	All-time highs	Collapsing	Normalizing
<b>Consumer</b>	Excess consumption	Deleveraging	Moderate consumption
<b>Fixed-Asset Investment</b>	Excessive	Falling sharply	Recovering slowly
<b>Source of Global GDP Growth</b>	< 50% emerging markets	>100% emerging markets	~ 66% emerging markets
<b>Valuations</b>	Modest expansion	Rock bottom	Normalizing
<b>Risk Premiums</b>	Historic lows	Historic highs	Declining

Source: T.Rowe Price. This information demonstrates, in part, the firm's analysis of the global economic landscape. This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action.

In this new backdrop, the author expects we'll see:

- Lower real economic growth in the medium term, in the 2% to 3% range;

<sup>12</sup> Bloomberg

<sup>13</sup> Bloomberg

## Due Diligence Forum Research Paper

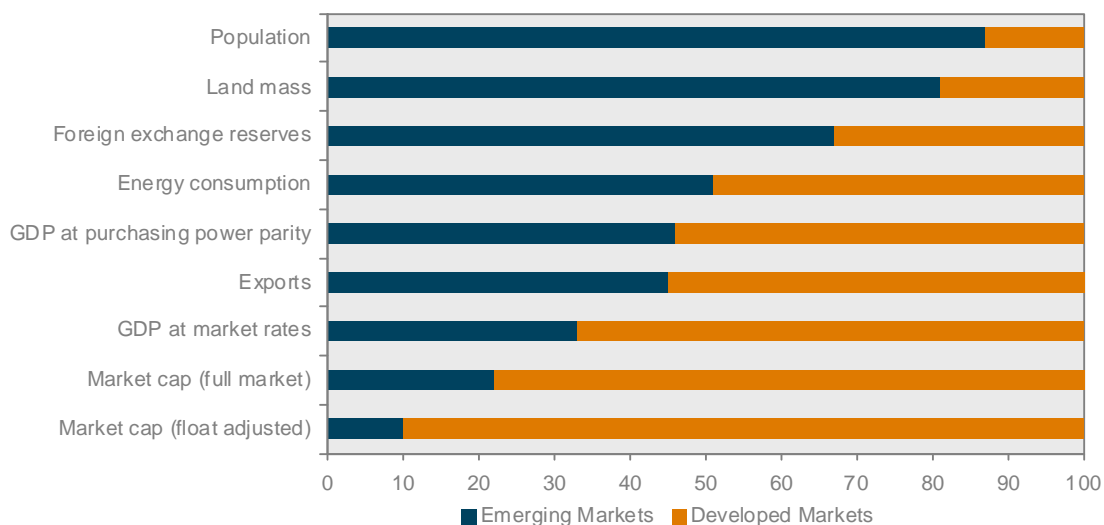
- Slowly rising interest rates and increased cost of capital;
- Moderate consumer spending and recovering fixed asset investment from a low base;
- A gradual return to corporate pricing power and improving profit margins; and,
- Equity risk premiums declining and valuations normalizing from historic lows.

One particularly important factor identified in this framework is that emerging markets are providing a rare beacon of economic growth as developed markets feel the full force of the current recession. Below are some of the factors that underpin such growth and substantiate the ongoing case for emerging market investing.

### Demographic and consumption trends remain compelling

Despite the events in 2008, GDP trends in emerging markets continue to be supported by demographic shifts. The growth of the labor force in emerging markets has been one of the most significant global demographic trends of the last 50 years, with the rise in the emerging market workforce far outstripping that of developed nations. In 1950, emerging economies had approximately 900 million people of working age, compared with a developed world figure of 500 million. By the turn of the new millennium, this proportion had changed, with a working population in emerging economies of 2.7 billion against a developed economy workforce of 800 million. Projections for 2050 show a widening of this gap – estimates suggest an emerging market workforce of almost 4 billion but an estimated drop in the number of developed workers to 700 million<sup>14</sup>. A demonstration of the total population split between developed and emerging markets is set out in Figure 6. The extent of this natural resource, together with other key indicators shown, demonstrates the significance of emerging markets within the global economy.

Figure 6: Emerging economies as a percent of total world – 30 April 2009



Source: Merrill Lynch calculations, BP, CIA World Factbook, IMF World Economic Outlook, MSCI Barra

<sup>14</sup> Bloomberg

**Due Diligence Forum Research Paper**

These demographic changes matter because not only is there a rapidly expanding pool of relatively low-cost labor, but, when used productively, there is also a commensurate increase in the number of consumers. The result of this growing consumer base is an organic stimulus. This is demonstrated by household consumption expanding by 7% per annum<sup>15</sup> in the emerging world, in contrast to the developed world, which is experiencing the dampening effect of lower consumption and a painful deleveraging process.

While this paper makes the case that we are in a transitional period and that developed markets will eventually resume an expansionary trend, the likelihood remains that as the global economy recovers from the fundamental challenges brought about by years of excess consumption, emerging market growth will account for an increased share of global growth, perhaps as much as two-thirds<sup>16</sup>. This contrasts starkly with the proportion of global equity indices attributable to emerging markets at around 12%<sup>17</sup>, and indeed suggests that the proportion of total global GDP attributable to the emerging world, which is currently 33%<sup>18</sup>, will continue to grow.

**Emerging market balance sheet strength remains**

In aggregate, emerging countries are in a much stronger structural position entering into this downturn than in past economic cycles. Many nations have used the period of robust growth since the 1998 emerging market crisis to build up substantial foreign currency reserves. Reserves had increased from about \$US845 billion in 2001 to \$US4 trillion by 2008<sup>19</sup>. Starting from such a position of strength has enabled many governments to adopt a proactive response to slower growth, most obviously in China, which has deployed the significant fiscal stimulus package mentioned previously, to offset a sharp correction in export-driven revenues.<sup>20</sup>

Looking at the emerging world in terms of savings and investment rates as a percentage of GDP, the picture is also an enviable one. With emerging market savings rates running at approximately 34% and investment rates running at 32%, it is easy to see why such a strong growth dynamic exists when compared with developed markets with savings rates at 17% and investment rates at 18%<sup>21</sup>. In essence, many emerging economies have both the ability to finance their investment through domestic savings and the willingness to use central resources and policy to stimulate domestic demand. An enviable position indeed, when compared with many developed nations, including the UK. With one of the most heavily indebted starting points amongst the developed nations, the UK is deploying a fiscal stimulus plan which is expected to lead to a fiscal deficit of 14% of GDP in 2010, the highest among the Group of 20 nations<sup>22</sup>.

---

<sup>15</sup> World Bank, EIU, DataStream, Morgan Stanley Research

<sup>16</sup> IMF, World Economic Outlook Database

<sup>17</sup> MSCI Barra

<sup>18</sup> IMF, World Economic Outlook Database

<sup>19</sup> IMF, World Economic Outlook, 2009

<sup>20</sup> UPI, 24 June 2009

<sup>21</sup> IMF, World Economic Outlook Database

<sup>22</sup> Bloomberg



**Due Diligence Forum Research Paper**

As well as a less leveraged consumer base, the overall health of the emerging market financial sector also compares favorably with that of developed markets. The financial sector which has seen so much government assistance in developed markets has emerged relatively unscathed within the emerging nations, mainly due to the relative simplicity of balance sheets and lower levels of overall leverage. Compared with the US and UK, where loans as a percent of GDP equal 172% and 138%, respectively, Brazil's loan penetration is 37% as a percent of GDP while Mexico and India are 24% and 41%, respectively<sup>23</sup>. Although credit markets were inevitably affected by wider issues in the global banking system, signs of credit expansion are already evident within India, China and Brazil, which is critical in achieving the spending and investment targets of governments. Through June 2009, Chinese banks have extended three times the amount of new loans offered in the same period a year earlier<sup>24</sup>. Similarly, in India, the Reserve Bank of India cut interest rates and the cash reserve ratio to help expand credit<sup>25</sup>. If domestic demand holds up and the financial sector maintains an ability to lend profitably, one more driver of emerging market growth remains in place.

**Long-term return potential remains compelling**

Although backward looking, the long-term evidence that emerging market exposure contributes to strong returns for global equity investors is compelling, despite the 2008 sell-off. Even excluding the rally of 2009, emerging markets have delivered strong gains, with the MSCI Emerging Market Index returned 112% cumulatively in the ten years ended 31 December 2008<sup>26</sup>. In comparison, its developed market counterpart, the MSCI World Index, lost 6% cumulatively in the same period, its worst rolling return over a 10-year time frame since the 1930s<sup>27</sup>. The evolution of emerging markets over the past decade should cause investors to look forward rather than backward; given that the asset class will tread a unique path over the next 10 years, however, with the positive dynamics highlighted above and below, there continues to be a compelling reason to invest in emerging market equities.

**REGIONAL AND COUNTRY VARIATIONS**

While this paper argues that emerging markets will continue to provide a rich source of future returns, divergence among countries and regions will always be a feature, given structural differences at the region and country levels. Understanding these differences, and how they relate to both opportunity and risk, will be crucial with respect to capturing the benefits of the significant opportunity presented.

Before reviewing the fundamental characteristics of emerging market regions, Figure 7 below illustrates some of the key features of the largest emerging economies.

---

<sup>23</sup> MF IFS, Central Bank Data, Merrill Lynch estimates as of 2007

<sup>24</sup> Bloomberg

<sup>25</sup> Reserve Bank of India

<sup>26</sup> MSCI Barra, in USD

<sup>27</sup> MSCI Barra, in USD

## Due Diligence Forum Research Paper

Figure 7: Emerging markets are not created equal – April 2009

	China	India	Russia	Brazil
Population	1,325m	1,140m	140m	190m
GDP	\$3,600b	\$1,200b	\$1,500b	\$1,500b
GDP per capita	\$3,000	\$1,100	\$12,000	\$8,500
Est. GDP growth 2009	6.5%	4.5%	-6.0%	-1.3%
Est. GDP growth 2010	7.5%	5.6%	0.5%	2.2%
Intl reserve assets	\$1,950b	\$245b	\$390b	\$200b
Est. inflation 2009	0.8%	4.3%	11.0%	4.2%
Current account deficit as % of GDP	10.3%	-2.5%	0.5%	-1.8%
Net oil exports (bbl per day)	-3.7m	-2.0m	6.3m	0.2m
% MSCI index in energy and materials	24%	32%	76%	57%

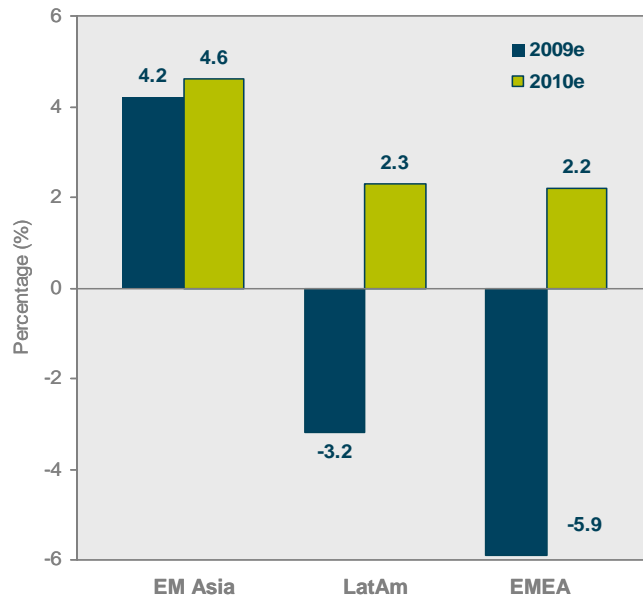
Source: IMF World Economic Outlook, MSCI Barra, Bloomberg. The Mexico index excludes the state-owned oil company Pemex

The divergence in natural resource ownership, demographics and economic health are very clear pointers to both the opportunities and risks that are apparent at the country and stock levels.

At the macroeconomic perspective, China and India can be expected to maintain positive growth trends in the near-term, albeit with China better equipped from a current account health (and indeed fiscal) perspective. The reliance of Brazil and Russia on energy revenues makes them more exposed to the energy cycle, a fact reflected in more subdued GDP estimates for 2009 and 2010.

Figure 8 below shows the growth trends by emerging market region, with a distinct trend apparent for 2009 GDP growth, between the resource rich (Latin America and Emerging Europe Middle East and Africa) and resource poor (Emerging Market Asia) regions.

Figure 8: Real GDP growth 2009 vs 2010 – 25 June 2009



Source: Morgan Stanley research

## Asia ex Japan

A diverse region, one common theme across Asia is that it does not have a solvency crisis. Savings rates are much higher than other areas of the world, with most Asian households and companies only modest borrowers. Total domestic debt (private and public) fell to 143% of GDP in emerging Asia for the calendar year 2007, compared with 251% of GDP in the US<sup>28</sup>. A lower level of indebtedness at the aggregate level should help to spur domestic economic growth through this period and, longer-term, enable Asia to avoid the burden of debt stockpiles that are being issued in both the US and Europe.

Asian sovereign balance sheets are also much stronger on average. The five emerging market countries with the lowest external debt/foreign-exchange reserves ratios are all Asian<sup>29</sup>. This balance sheet strength has enabled earlier and more aggressive counter cyclical policy action, particularly in China. Asia, as a whole, is a large net importer of raw materials and hence also benefits from any fall in commodity prices<sup>30</sup>.

Microeconomic trends include Southeast Asia, which has seen particularly strong trends in domestic consumption growth, led by China. Its private consumption as a percent of US personal consumption has increased from 25% in 1999 to 38% in 2008<sup>31</sup>, and this consumption trend shows no sign of slowing. Elsewhere, an example of the speed and magnitude with which the emerging market

<sup>28</sup> IMF IFS, Central Bank Data, Merrill Lynch estimates

<sup>29</sup> IMF, World Economic Outlook Database

<sup>30</sup> IMF, World Economic Outlook Database

<sup>31</sup> CEDC Data, CLSA Asia Pacific Markets

## Due Diligence Forum Research Paper

consumer can move is the adoption of mobile phone usage in India. The number of new Indian mobile phone subscribers topped more than 15 million a quarter in 2008, which is roughly equivalent to three-quarters of the population of Australia<sup>32</sup>. As wireless telecommunications reach a saturation point in the developed world, those countries with growing populations are inevitably a source of potential.

To cope with an ever-expanding population, investment in infrastructure projects will continue and has been prioritized within China and India. As export demand has fallen, infrastructure projects have been brought forward to maintain domestic employment and income levels. Examples include the investment being undertaken in China's railways, where track spending increased from Rmb53 billion in 2003 to Rmb330 billion in 2008<sup>33</sup>. Separately, India has recognized the requirement for new highways and as a result, the government of India has sanctioned the modernisation of 6,500 km of national highways, including 5,700 km in the so-called Golden Quadrilateral area connecting Delhi, Mumbai, Kolkata and Chennai<sup>34</sup>. Given differing political approaches and the starting point that India's fiscal position is not as strong as China's, the Indian government is implementing its goals through private finance initiatives, creating a source of opportunity for the next decade.

Despite the positive trends highlighted, with greater exposure to the export sector, many Asian economies have suffered a sharp slowdown led by the technology-dominated Taiwan and Korea, where GDP is forecast to be -7.4% and -4.0%, respectively, in 2009<sup>35</sup>. Across the region, growth in exported goods and services is expected move from a level of 10.3% in 2008 to -9.1% in 2009<sup>36</sup>. With clear cyclical exposure, both countries are heavily reliant on normalizing global spending patterns and a resumption of trade levels. This was reflected in the Taiwan TAIEX Index and the Korean KOSPI Index falling by 60% and 70%, respectively (in USD) peak to trough in 2008<sup>37</sup>. Should global trade levels improve, particularly in conjunction with a further catalyst of global restocking, then this piece of the Asia region is likely to thrive once more as a key source of low-cost technology.

### Latin America

The Latin America region encompasses a number of dynamic markets, with Brazil and Mexico the economic powerhouses within the region composing around 80% of the MSCI Latin America Index<sup>38</sup>. The region has a vast supply of natural resources and a young and growing population and has seen the emergence of a consumer sector that is growing in size and importance<sup>39</sup>.

Despite an attractive demographic profile, the region experienced some of the most extreme volatility in 2008. In the last quarter of 2008, the median Latin America sovereign yield in the JP

---

<sup>32</sup> Merrill Lynch Research

<sup>33</sup> *Barron's*, 9 March 2009

<sup>34</sup> National Highways Authority of India

<sup>35</sup> IMF, World Economic Outlook Database

<sup>36</sup> IMF, World Economic Outlook Database

<sup>37</sup> Bloomberg

<sup>38</sup> MSCI Barra

<sup>39</sup> World Bank, IMF

## Due Diligence Forum Research Paper

Morgan EMBI Global Index nearly doubled from 5.6% to 10.0%<sup>40</sup> as fears grew that historical links between economic turmoil and currency devaluations would resurface. The primary reason underlying the volatility was the link to commodity prices, long regarded as the driver for Latin American economic health and hence equity valuations. With oil prices (West Texas Intermediate) touching \$US146 a barrel at its upper limit before falling to \$US44 a barrel<sup>41</sup>, the economic implications are clear. Such a shock to the region's finances overshadowed the positives that can be drawn from the region, including that many Latin American economies are fairly closed (with low export/GDP ratios, by global emerging market standards). While Mexico is a significant exporter to the US and is inexorably linked to US spending, the average ratio for the rest of the region is only 5%<sup>42</sup>. This should, in principle, mean that most countries are better insulated against any slowdown in global trade levels.

Although the economic health of South America's largest countries invariably cannot be separated from commodity prices, the bourses of Latin America are experiencing change, and the potential for investors remains extremely broad. In Brazil, there has been an emergence of domestic-led growth which has seen consumer-related sectors become an increasing part of the makeup of equity indices<sup>43</sup>. With a population of nearly 200 million people, the country is rich in demographic as well as resource terms<sup>44</sup>. Examples are numerous but include healthy demographics backed by rising income levels driving both emerging and developed wireless telecommunication companies to exploit spending patterns. With the average minutes of use in Brazil eight times lower than in the US and four times lower than in India or China<sup>45</sup>, scope for further voice and data usage is large. Similarly, an underpenetrated banking system (outstanding mortgage loans compose around 2% of GDP in Brazil, compared with 80% in the US<sup>46</sup>) and a competitive environment within the finance sector that allows for some of the highest net interest margins in the world (Brazil at 7.5% in comparison to the UK at 3%<sup>47</sup>), the national banking systems are well positioned to benefit from these changing patterns in domestic consumption.

Any further falls in commodity prices will, of course, have a negative effect on fiscal balances. Economic growth has certainly slowed, but, importantly, growth for the region as a whole should recover into 2010, with Brazil at the vanguard<sup>48</sup>. Fiscal and current-account balances are also much better than in previous downturns<sup>49</sup>. This should create flexibility to ease fiscal policies in a number of countries. Lower headline inflation should also allow central banks (unusually for them at this stage of an economic cycle) to continue (if necessary) reducing interest rates aggressively in 2009, assisting economic growth and supporting equity valuations.

---

<sup>40</sup> IMF, Regional Economic Outlook: Western Hemisphere, May 2009

<sup>41</sup> Bloomberg

<sup>42</sup> IMF, Regional Economic Outlook: Western Hemisphere, May 2009

<sup>43</sup> MSCIBarra

<sup>44</sup> CIA World Fact Book

<sup>45</sup> Merrill Lynch, T. Rowe Price International

<sup>46</sup> Credit Suisse Research

<sup>47</sup> World Bank, IFC, UBS

<sup>48</sup> IMF, World Economic Outlook, April 2009

<sup>49</sup> Bank of America Merrill Lynch, July 2009

## EMEA

The Emerging Europe, Middle East and Africa (EMEA) region is rich in natural resources but in the short term may be more vulnerable to a weak global economy, as reflected by discounted market valuations as of June 2009 and a more muted bounce in overall market levels<sup>50</sup>. Commodity-driven revenues falling has sharply slowed many countries with the biggest index constituents Russia and South Africa expected to see growth of -6.0% and -0.3% in 2009, respectively<sup>51</sup>. In Eastern Europe, where support proved critical to stability as credit markets dried up<sup>52</sup>, the IMF was still discussing aid programs with at least 10 governments<sup>53</sup> as of July 2009.

In comparison to Asia and the stronger South American countries, most Eastern European nations have large current-account deficits and few, if any, foreign currency reserves (excluding Russia), while Russia may run its first current-account and budget deficits in over a decade as its economy contracts sharply in 2009<sup>54</sup>. These factors will clearly provide a headwind to both near-term sentiment and growth trends, albeit this does create an attractive valuation case for long-duration investors. Looking further ahead, positive demographic trends remain in place. Emerging Europe has a population similar in size to Western Europe but with much lower income levels<sup>55</sup>. If near-term imbalances can be resolved, the trend of rising fixed investment, productivity gains and export competitiveness as local currencies have devalued should continue to aid wealth creation and income levels, which should in turn continue to support domestic growth.

With respect to Africa and the Middle East, the regions have fared well through July 2009 with respect to credit losses. South Africa's currency controls have provided an inadvertent barrier to significant US subprime losses whilst elsewhere, nonperforming loans at 1% in the UAE in compare favourably to 3.5% in the UK and 5% in Eastern Europe<sup>56</sup>. Relatively low losses to date are in spite of a significant property bubble across the region encapsulated by Dubai, where commercial property prices doubled between January 2007 and September 2008<sup>57</sup>. Prices have fallen by 55% to May 2009. Despite the sharp market sell-off in 2008<sup>58</sup>, economies in most of the Middle East region remain robust, whilst many countries have amassed vast reserves during the commodity bull market<sup>59</sup>. Five of the top ten countries by current account balance reside in the Middle East<sup>60</sup>. Slower global growth and the drop in commodity prices from 2008 peaks will have an impact near-term, but domestic demand is likely to be underpinned by government spending commitments whilst global energy consumption and oil prices remain depressed.

---

<sup>50</sup> UBS, MSCI Barra

<sup>51</sup> MSCI Barra, World Economic Outlook Database

<sup>52</sup> IMF, World Economic Outlook, April 2009

<sup>53</sup> Bloomberg

<sup>54</sup> IMF, World Economic Outlook Database

<sup>55</sup> IMF, World Economic Outlook Database

<sup>56</sup> Regional Economic Outlook: Middle East and Central Asia, May 2009

<sup>57</sup> Regional Economic Outlook: Middle East and Central Asia, May 2009

<sup>58</sup> MSCI Barra

<sup>59</sup> IMF, World Economic Outlook Database

<sup>60</sup> IMF, World Economic Outlook Database

## **CONCLUSION**

This paper argues there is still a strong case for emerging market exposure. Indeed, given the likelihood of an environment of lower global growth in the medium term, emerging markets are arguably as important as ever within a global portfolio, despite the additional volatility that will always be prevalent in such markets. While there are obvious concerns over current global economic conditions and great uncertainty regarding future growth estimates, fundamentals in emerging markets remain compelling, and the positive long-term dynamics are hard to ignore. We believe growth in emerging markets represents a secular trend with tremendous investment prospects looking further forward.



## Due Diligence Forum Research Paper

*This information demonstrates, in part, the firm's analysis of the global economic landscape. This material is provided for informational purposes only and is not intended to be investment advice or a recommendation to take any particular investment action. Information contained herein is based upon sources we consider to be reliable. We do not, however, guarantee its accuracy. Past performance cannot guarantee future results. All charts and tables are shown for illustrative purposes only. The views contained herein are as of 28 July 2009 and may have changed since that time.*

*This material is provided for informational purposes only and is not intended to be a solicitation for any T. Rowe Price products or services. This material is being provided to explore potential business opportunities in China and recipients are advised that T. Rowe Price shall not offer any products or services without an appropriate license or exemption from such license. This material may not be redistributed without prior written consent from T. Rowe Price. Issued in the U.S. by T. Rowe Price Associates, Inc., 100 East Pratt Street, Baltimore, MD 21202, which is regulated by the U.S. Securities and Exchange Commission. The material is not intended to be a solicitation for any product or service not available to U.S. investors, including the T. Rowe Price Funds SICAV, and may be distributed only to institutional investors. Issued in Japan for purposes of its investment management business by T. Rowe Price Global Toshi Komon—Tokyo Branch (TRPGTK) (KLFB Registration No.445 (Financial Instruments Issued in Japan for purposes of its investment management business by T. Rowe Price Global Service Provider), JSIAA Membership No. 011-01162), located at Yamato Seimei Building 20F, 1-7, 1-chome Uchisaiwai-cho, Chiyoda-ku, Tokyo 100-0011. If instead this material is used in Japan on behalf of an affiliated T. Rowe Price company, TRPGTK has compiled, translated, and provided this material. This material is intended for use by professional investors only. Issued in Canada by T. Rowe Price (Canada), Inc. T. Rowe Price (Canada), Inc., enters into written delegation agreements with affiliates to provide investment management services. T. Rowe Price (Canada), Inc., is not registered to provide investment management business in all Canadian provinces. Our investment management services are only available to select clients in those provinces where we are able to provide such services. This material is intended for use by accredited investors only. Issued in Australia by T. Rowe Price Global Investment Services Limited (TRPGIS), Level 29, Chifley Tower, 2 Chifley Square, Sydney, NSW 2000 Australia. TRPGIS is exempt from the requirement to hold an Australian Financial Services License (AFSL) in respect of the financial services it provides in Australia. TRPGIS is regulated by the FSA under U.K. laws, which differ from Australian laws. This material is not intended for use by Retail Clients, as defined by the U.K. FSA, or as defined in the Corporations Act (Australia), as appropriate. Issued in New Zealand by T. Rowe Price Global Investment Services Limited (TRPGIS). TRPGIS is regulated by the FSA under UK laws, which differ from New Zealand laws. This material is intended only for use by persons who are not members of the public, by virtue of section 3(2)(a)(ii) of the Securities Act 1978 and is not intended for public distribution nor as a solicitation for investments from members of the public. This material may not be redistributed without prior written consent from TRPGIS. Issued outside of the U.S., Japan, Canada, China, Australia and New Zealand by T. Rowe Price Global Investment Services Limited, 60 Queen Victoria Street, London EC4N 4TZ, which is regulated by the U.K. FSA. This material is not intended for use by Retail Clients, as defined by the U.K. FSA. T. Rowe Price, Invest With Confidence, and the bighorn sheep logo is a registered trademark of T. Rowe Price Group, Inc., in the United States, European Union, Australia, Canada, Japan, and other countries. This material was produced in the United Kingdom. 87584*