

Strategy Matters

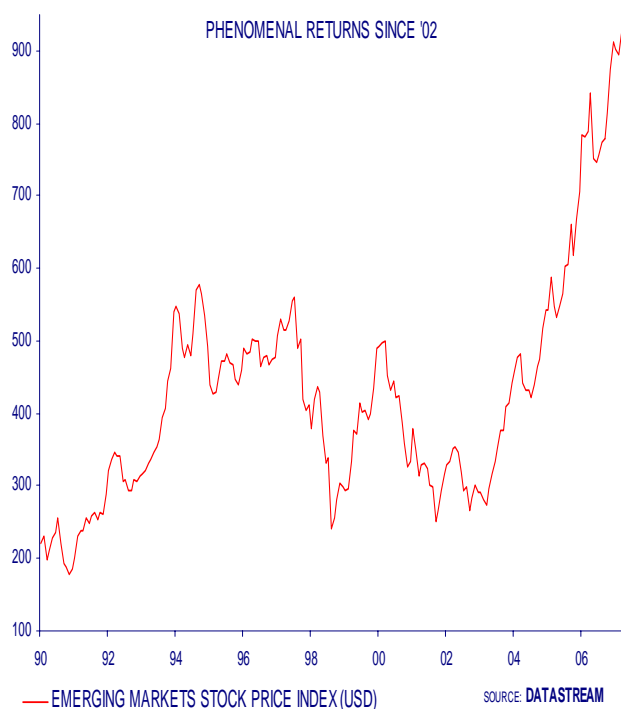
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Has the Emerging Markets rally run its course?

Anyone who bought emerging market (EM) equities in and around 2002-03 has seen their money more than triple since then in U.S. dollar terms. The meteoric rise in EM stocks has some investors smiling and others wondering whether it's too late to 'get in' now.

A different asset class...

Emerging market (EM) stocks have gone up 264% since October 2002 and most investors who opted to keep their exposure to the sector low or nil will have thought twice about their decision to do so and whether it's too late to get involved. Alternatively, investors that did invest in the rally and are sitting on a healthy profit are probably wondering whether EM is due for a classic, potentially crisis-induced, correction/bear market and hence should they take profits.

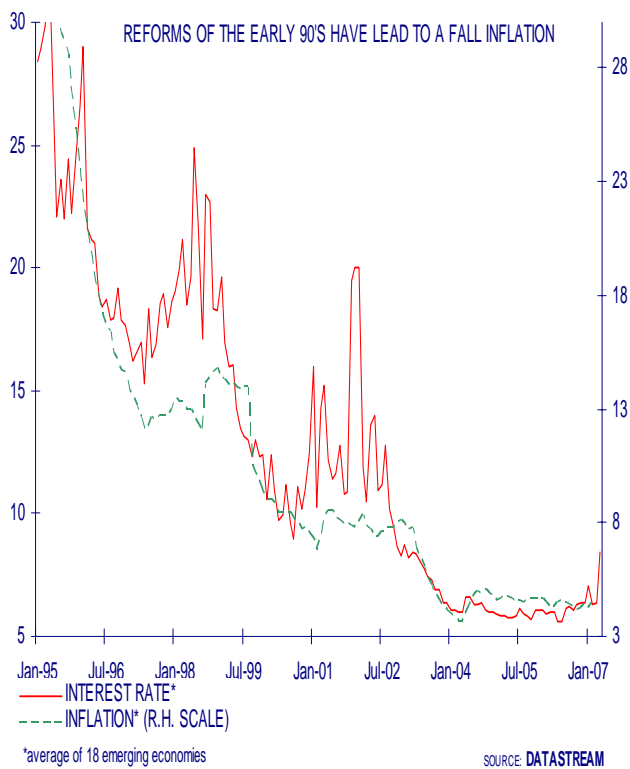


Our belief is that the latter scenario is unlikely. There is always potential for crisis, however the current environment which emerging markets find themselves in is not one conducive to a classic boom/bust swing in economic activity followed by a currency devaluation or a debt default.

Emerging economies owe much of their current fortune to the difficult reforms which they implemented throughout the 1990's. These changes ranged from policies geared toward better tax collection to reduction of foreign debt in favour of local. The latter was previously impossible as most EM countries lacked a captive domestic local market for debt and capital controls, another pre-reform stalwart, made it difficult for foreigners to be active in local markets. In addition to switching from foreign to local issuance, a practice which has left governments less exposed to currency risk whilst servicing their debt, EM countries reduced their gross debt loads, cutting their aggregate debt-to-GDP ratio from 37.8% in 1998 to 34.1% in 2006.

EM countries were able to achieve this debt reduction through various fiscal measures. In the case of emerging Europe, the fiscal requirements under the growth and stability pact, which are a precursor to entry into the European Monetary Union (EMU), forced countries such as The Czech Republic, Poland and Slovakia to run more fiscally austere programs. In the case of Brazil and Russia, a combination of higher tax revenues, helped by a cyclical backdrop that kept prices for commodities (which both countries have an abundance of) elevated, and lower government spending, the direct result of previous legislation, brought the same result.

Of all the reforms, however, none was more important than the move by the central banks of a number of EM countries to inflation targeting regimes. Of course, this could not have been achieved without full central bank independence which was the legislative precursor to inflation targeting in almost all these countries. Once EM central banks adopted inflation targeting en masse and fiscal reforms began to have traction, inflation came down and interest rates along with it. The combination of falling inflation/interest rates and strong growth set the stage for the equity rally of recent years.

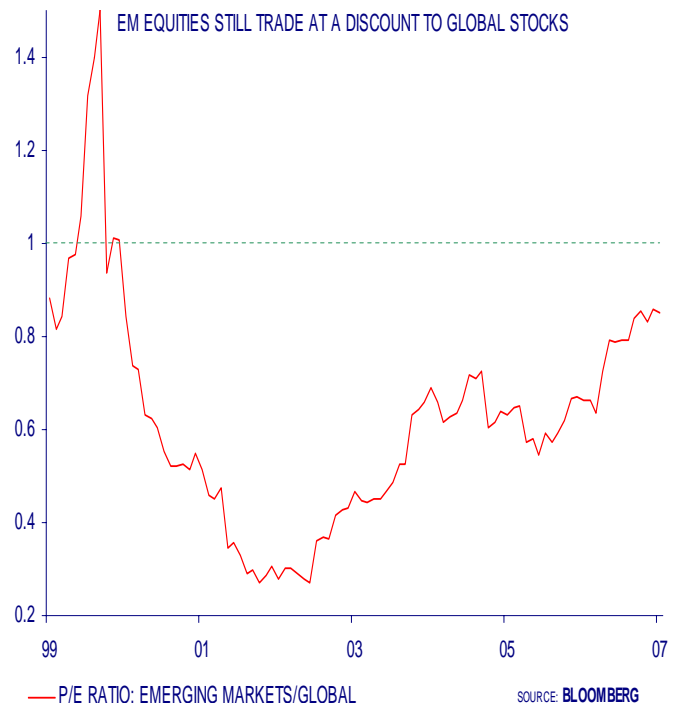


So, is the equity rally over?

The answer is a conditional no. The EM equity rally has coincided with a global bull market. EM being the growth oriented, high beta play it is, benefited more than G7 bourses have. Structurally speaking, nothing has changed in EM. Inflation remains low, debt levels continue to fall and central banks, for the most part, remain vigilant.

Cyclically, however, the picture is less clear. From a valuation perspective emerging market equities trade at a discount to global stocks on a

P/E basis and by most other valuation measures.



Trailing earnings growth has fallen to 12.1% year-on-year (y/y) from a cyclical peak of 24.4% but remains in double digit territory. Forward earnings growth, which has consistently undershot trailing this cycle, is projected at a healthy 8.7% y/y rate. Where the uncertainty lies, however, is in the global growth outlook. A number of global leading indicators remain subdued; after rising in the August-November 2006 period, the 3-month rate-of-change on the OECD Leading Economic Indicator fell the following two months, while the U.S. Conference Board Leading Economic Indicator has fallen into negative territory for only the tenth time in forty seven years.

However, all is not gloomy. Though the U.S. PMI indices fell in recent months, they have held in around the 50 mark, indicating that the economy continues to expand, albeit at a moderate pace. At the same time, European growth continues to surprise on the upside and both the analyst (ZEW) and business (IFO) communities remain upbeat on EMU growth. Finally, China once again surprised the

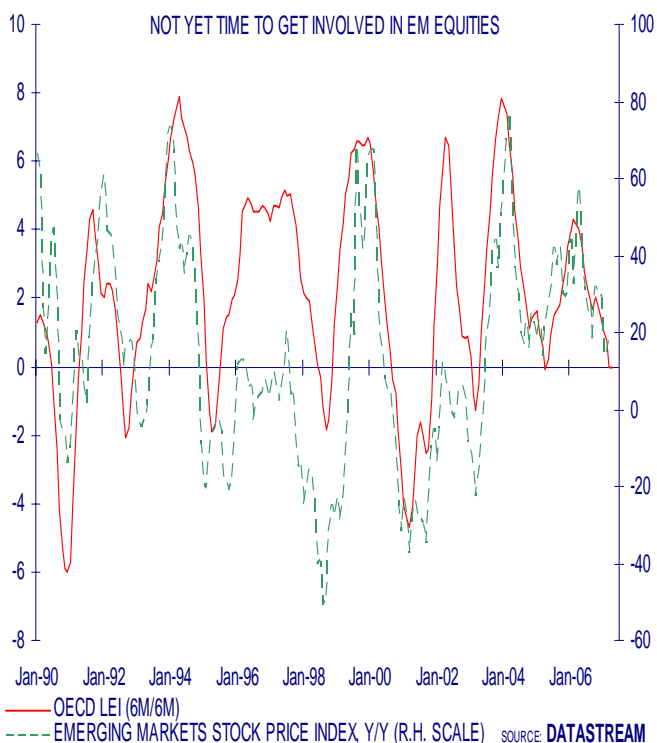
investment community when it reported stronger than expected 11.1% over-year-ago first quarter GDP growth. In addition, a number of other economies in Asia, and throughout the emerging markets are enjoying reasonable growth. Such dynamics are EM stock friendly.

Conclusion

Until one or more of the risks highlighted in the previous section materializes, there is nothing to stop emerging market equities from grinding, albeit nervously, higher in the short/medium term. However, positive long-term equity market performance is contingent upon the continuation of reforms which began in the previous decade. A good portion of EM countries will need to push through difficult reforms concerning tax, social security and pensions. This will be a challenge in the years to come, as the nature of EM politics can make the legislative process difficult.

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Henderson Global Investors



Look for stronger signs of a global growth pickup

EM equities have indeed rallied 7.3% since the beginning of the year, in response to their benign scenario. What is even more compelling is that EM stocks have broken above their previous high, achieved prior to the end of February correction. However, with the global growth outlook still uncertain, there is the potential for excessive investor exuberance. The recovery in the global manufacturing cycle remains tepid and a resumption of weakness in this sector, a more prolonged and severe fall in the U.S. housing market or more aggressive curbing of investment by the Chinese authorities are just three of a slew of risks which could derail the global economy and the EM rally along with it.

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