

## Emerging Markets to Lead Stocks, Boosted by Consumer Shares

By Michael Tsang

Jan. 2 (Bloomberg) -- Emerging-market stocks may lead global equity returns for a sixth straight year because consumers from China to Brazil are becoming wealthy enough to propel economic growth even as demand for their exports slows.

Investors are targeting telephone companies and banks to profit from growing domestic spending after Chinese wages doubled during the past five years, Brazil's interest rates tumbled to the lowest in two decades and loans from Indian banks jumped 35 percent in the past two years.

"We see emerging markets as a bright spot in terms of earnings growth in 2007," said Alan Brown, who oversees \$229 billion as head of investments at Schroders Plc in London. His firm is "overweight" shares of developing countries.

UBS AG, JPMorgan Chase & Co. and Credit Suisse Group predict the Morgan Stanley Capital International Emerging Markets Index will climb as much as 15 percent this year. Gains may slow from the MSCI index's 29 percent rise in 2006 because emerging-market equities are the most expensive since 1999 relative to stocks in developed nations, according to UBS.

MSCI's Emerging Markets Index, tracking 25 markets in Asia, Eastern Europe, Latin America and the Middle East, ended the year at an all-time high of 912.65. The index bounced back from a global slump in May and June to beat stock benchmarks in developed countries.

The Standard & Poor's 500 Index rose 14 percent for the year, Europe's Dow Jones Stoxx 600 Index gained 18 percent and MSCI's Asia-Pacific Index climbed 15 percent. MSCI's World Index of developed markets jumped 18 percent in 2006.

### Winning Streak

The MSCI emerging-markets measure completed a fourth straight year of gains, the longest streak in its 19-year history. Since the bull market began in 2002, the index has more than tripled.

Shares of China Life Insurance Co., the nation's biggest insurer, almost quadrupled, while OAO Rostelecom, Russia's largest long-distance telephone company, tripled in value.

Mark Mobius, who oversees \$30 billion in emerging-market equities at Templeton Asset Management Ltd. in Singapore, says the biggest opportunities are companies that benefit from consumers' growing affluence and willingness to spend.

Developing economies will expand 6.4 percent in 2007, led by China and India, the world's two most populous nations, according to World Bank estimates. That's more than twice as fast as the 2.4 percent pace for high-income countries. The U.S. economy is expected to grow 2.1 percent, according to the bank.

## Chinese Wages

In China, per-capita disposable incomes in towns and cities, where more than 500 million people live, rose 10 percent in the first nine months of 2006 from a year earlier. In India, the number of households earning an annual income of at least \$10,000 is rising more than 20 percent a year, according to consultants McKinsey & Co. in New York.

Corporate and consumer lending in India has expanded more than a third in the last two fiscal years.

An MSCI index of food and beverage stocks in China soared 89 percent in 2006. A gauge of companies in India that make cars and other big-ticket items jumped 39 percent. In the U.S., by comparison, Procter & Gamble Co., the world's biggest consumer products company, rose 12 percent.

“Consumers are now rising to the top of the heap,” said Mobius. “We’re not only talking about consumer products, but consumer services” such as banking and insurance.

Profits for developing-nation companies that rely on consumer spending will increase an average 30 percent this year, the biggest year-on-year gain for any industry, according to Oussama Himani, UBS's emerging-markets strategist in London.

The estimate is higher than the 19 percent average growth forecast for all companies in emerging markets, and almost triple the firm's estimate for companies in developed markets.

## China Mobile, Sberbank

Himani's favorites include China Mobile Ltd., the world's largest mobile-phone operator by users, Urbi Desarrollos Urbanos SA, Mexico's largest homebuilder by market value, and OAO Sberbank, Russia's biggest lender.

Adrian Mowat, JPMorgan's Hong Kong-based emerging markets strategist, recommends Chinese real-estate companies including China Overseas Land & Investment Ltd., controlled by China's construction ministry.

“It's a pretty fertile environment for companies to prosper,” said William Fries, who runs the \$7.5 billion Thornburg International Value Fund in Santa Fe, New Mexico. The fund has 25 percent in emerging markets and China Merchants Bank Co., the country's most profitable lender, is a top-10 holding.

## No Longer Cheap

James Moffett, who oversees the \$2.8 billion UMB Scout International Fund in Kansas City, Missouri, is wary of emerging markets because they're no longer as cheap relative to stocks in developed countries.

Emerging-market stocks sell for 15.2 times forecast company earnings, compared with 16 times for developed countries as a whole, according to data compiled by Bloomberg.

According to UBS, emerging markets are about 20 percent less expensive than developed markets, based on MSCI indexes, the smallest discount since 1999. At the start of the emerging-market rally four years ago, stocks sold for about 50 percent less.

Colombia is the most expensive emerging market, selling for 162 times estimated earnings.

Among the biggest developing nations, India is the most expensive. Companies in the Sensitive Index, or Sensex, are valued at 20.3 times forecast earnings, in aggregate. So-called H shares of Hong Kong-listed Chinese companies that foreign investors can freely buy and sell trade at 18.8 times.

The MSCI World Index is valued at 16.1 times.

#### Piling On

“A lot of people have piled on,” said Moffett. “Some markets such as China and India have run pretty hard and are a bit overvalued.” He’s cut his emerging-market holdings to 10 percent of assets from 15 percent a year ago.

Gains in stocks will slow this year, according to Credit Suisse. The Zurich-based firm forecasts an advance of 10 percent to 15 percent and recommends investors “overweight” shares of South Africa, Egypt and the Czech Republic. JPMorgan forecasts an almost 10 percent return in dollar terms.

That compares with an average gain of about 8 percent for the S&P 500 Index that U.S. strategists predict.

Infrastructure spending may help developing countries and make their markets less vulnerable to a slowdown in exports to the U.S. For the next 25 years, about 1 million people each week will move into towns or cities in developing countries around the world seeking higher-paying jobs, according to Merrill Lynch & Co., citing estimates from the United Nations.

#### Roads and Power

That will increase spending on roads, power generation and public transportation. Merrill last month raised its forecast for infrastructure spending by 42 percent to \$1 trillion over the next three years.

“Infrastructure and consumer spending represent the best secular themes in emerging markets,” said Michael Hartnett, Merrill’s New York-based emerging-markets strategist.

His top picks include Emaar Properties PJSC, the largest property developer in the Middle East, Bharat Heavy Electricals Ltd., India's biggest power-equipment maker, and Mexico's Cemex SA, the world's third-largest cement maker.

Indexes in 14 developing countries reached all-time highs last month, led by Brazil, Russia, India and China. Emerging markets recouped the biggest losses in four years, when the MSCI index plummeted 25 percent in 26 days -- between May 8 and June 13 -- on speculation that higher interest rates around the world would slow economic growth and reduce the appeal of riskier assets.

#### Year-end Rally

The last time the gauge fell more from peak to trough was a 30 percent drop over six months from April to October 2002.

After slumping to its low on June 13, the emerging-markets measure rallied 37 percent to the end of 2006 as companies reported higher profits, prices of commodities rebounded and the Federal Reserve stopped raising U.S. interest rates.

Emerging-market stock funds received a record \$22.4 billion on a net basis last year, eclipsing the high of \$20.3 billion in 2005, according to Emerging Portfolio Fund Research, a Cambridge, Massachusetts-based firm.

China-related funds accounted for half the total net inflows into emerging markets. Chinese stocks had seven of the 10 biggest advances in the MSCI Emerging Markets index.

The Hang Seng China Enterprises Index of Hong Kong-listed mainland companies surged 94 percent, buoyed by the fastest growth of any major economy and the world's biggest initial public offering -- Industrial & Commercial Bank of China Ltd.'s \$22 billion share sale.

#### Winners and Losers

Gains in Russia helped Eastern Europe record the biggest advance regionally. The dollar-denominated Russia Trading System Index surged 71 percent, becoming the first developing country to top \$1 trillion in market capitalization.

Brazil's Bovespa Index rose 45 percent in dollar terms and the Sensitive Index jumped 47 percent.

Peru's Lima General Index had the biggest advance of any emerging market, tripling in value as exports of copper, gold and fishmeal lifted economic growth to an 11-year high.

The Middle East had nine of the 10 worst performing stock markets, imploding after a three-year, 267 percent surge in the Dow Jones DIFC Arabia Titans 50 Index. The Tadawul All-Share Index in Saudi Arabia, the region's biggest market, lost 53 percent, the steepest slide of 81 indexes tracked by Bloomberg.

Schroders' Brown said governments in emerging markets are in better fiscal shape, so there's little chance of a meltdown like the defaults and currency devaluations that swept the nations in the late 1990s. Growth at home will hold up for developing countries even as the U.S. economy slows, he said.

“The painful memories of emerging-market crises are receding in people's minds,” he said.