



Emerging Markets and the Global Financial Crisis

Emerging Markets are Victims of their Own Success

A sharp slowdown in global economic growth in 2009 is no longer in doubt. What is still uncertain, however, is the magnitude of the slowdown. World financial markets are already discounting a sharp fall in GDP growth in the fourth quarter of this year, extending through to end-2009, but the single-biggest threat to the global economic outlook is the expected dramatic contraction in US household balance sheets over the next few years in what is likely to be by far the largest consumer retrenchment since the second world war. US household debt growth almost stalled in the second quarter of this year and in the three months to September may have been negative for the first time in the post-war era.

Continued declines in US housing market indicators point to further falls in the value of household real estate holdings, while huge falls in the Dow Jones Industrial Average, S&P500 and NASDAQ 100 stock-market indices since the start of the year have also undermined confidence. Further weakness in the latest monthly reading of the S&P/Case-Shiller home-price index that measures home prices in 10 major US metropolitan areas, showed prices in August continued to decline, falling by a record 17.7% from a year earlier and by 1.1% from July, suggesting that a levelling out of home prices is still nowhere in sight. Both the 10-city and 20-city composite indices have shown year-on-year home price declines for 20 consecutive months, while August marked the 11th consecutive record monthly decline in the 10-city index. European and UK housing markets are also in trouble.

Recent government bailouts of banking systems in developed-market economies at enormous cost to taxpayers have gone hand in hand with emergency coordinated central bank monetary policy easing to reduce borrowing costs in an attempt to get interbank lending markets functioning normally again. While government-led rescues of financial institutions deemed to be 'too big to fail' have significantly reduced systemic risk, and will help contain the financial fallout from the current global credit crisis, government-mandated solutions will not provide a permanent fix for the fundamental problems that will cause the sharp downturn in the global economy in the coming year. The cost of the financial system bailout will become increasingly apparent in ballooning government deficits in the G7 countries.

Market fears about the risk of further bank failures have now given way to worries about the risk of country defaults in certain emerging-market economies and the increasing problems being experienced by the global hedge fund industry and other large investment funds, in which several large hedge funds are widely reported to have been forced sellers to meet investor redemptions/withdrawals, and a number of which have had to suspend redemptions to ease the pressure. Forced selling by investors in previously outperforming asset classes, to meet margin calls and redemption requests elsewhere, have made the emerging-market asset class a victim of its own success.

While latest data clearly show the world economy is slowing, emerging-market economies are still set to grow at a faster rate than the advanced industrialised economies in 2009 and beyond. Fast-growing domestic markets in the emerging world, especially those with big and increasingly affluent populations such as Brazil, China, India and Russia, provide developing countries with a strong buffer to help insulate them from the

effects of the downturn rapidly taking hold in the developed countries. Emerging-market economies will not escape unscathed from the recession in the G7 area that is now inevitable, but the impact on growth in the developing world will be significantly less than would have been the case a decade ago, when a number of emerging-market economies suffered from serious structural imbalances.

Growth and Current-Account Data for Emerging Market Economies

	GDP Growth 2008F (% y/y)	GDP Growth 2009F (% y/y)	Current- account Balance, \$bn*	Current- account Balance (% of GDP 2008F)
Argentina	6.0	3.5	6.0	3.1
Brazil	4.6	3.4	-21.9	-1.6
Chile	3.9	3.3	1.0	-0.5
Mexico	2.3	2.5	-5.3	-0.8
Czech Rep.	4.5	4.3	-4.3	-2.8
Hungary	2.0	3.0	-8.8	-5.5
Poland	5.4	4.3	-26.3	-4.9
Russia	7.5	6.8	104.3	6.2
Turkey	3.7	3.2	-48.7	-6.4
Israel	4.2	2.8	3.5	0.9
South Africa	3.4	3.3	-22.5	-7.7
China	9.8	8.5	371.8	8.5
India	7.3	6.8	-21.9	-2.9
Indonesia	5.8	5.5	6.3	2.8
South Korea	4.6	3.3	-7.1	-3.3
Malaysia	6.0	5.6	35.3	14.4
Philippines	4.5	3.9	4.3	2.0
Taiwan	4.3	3.4	32.6	4.6
Thailand	4.8	3.9	7.8	1.1

*Latest 12 months. F is for forecast.

Source: The Economist

A decade and more of economic reform by emerging-market governments since then has addressed many of these imbalances, though the reform process is not complete in some cases. The adoption by central banks of more flexible currency exchange-rate policies allowing the external accounts to absorb exogenous economic shocks through free-floating or managed floating exchange rates, granting of independence to central banks, promotion of free-market economics by developing-country governments and careful nurturing of domestic demand have all contributed to their economic development.

Data from US bank JP Morgan covering 25 emerging-market economies in Asia, Eastern Europe and Latin America show sovereign external debt as a proportion of GDP in emerging-market economies has been significantly reduced over the past decade from a peak of 18.9% in 1999

to 7.0% in 2007, a forecast 6.2% this year and 5.9% in 2009, while since 1998, the total sovereign debt-servicing burden of these same countries fell from a peak of 16.5% of GDP to just over 3% in 2007 and 2008. External vulnerability has been significantly reduced. The success of a number of emerging-market countries in developing local-currency domestic-debt markets, particularly in Latin America, has also helped reduce reliance on external borrowing. Meanwhile, emerging markets' total foreign exchange reserves surged from \$766bn in 2000 to a forecast \$4,404bn this year, with further reserves growth to \$4,666bn forecast in 2009. Since 1999, the same 25 emerging-market economies boosted their combined nominal GDP from \$4,973bn, to \$12,816bn in 2007, a forecast \$15,111bn this year and \$16,455bn in 2009 in line with their growing contribution and importance to the global economy.

The Growing Role and Influence of Sovereign Wealth Funds

The rapid growth of Sovereign Wealth Funds in recent years has been fuelled primarily by sustained high energy and commodity prices and surging income growth in the larger emerging-market economies, the accumulation of excess foreign exchange reserves and the desire to seek higher investment returns. Sovereign wealth funds have been created, controlling an estimated \$3.8 trillion in assets, a number of which are based in emerging Asia and the Middle East. Most of the world's 15 largest Funds are in emerging-market countries, the majority of which depend on oil as their main source of funds. An estimated 62% of their inflows are from oil and gas-related revenues, with the balance financed from non-energy sources.

The World's Largest Sovereign Wealth Funds (Assets Under Management)

Country	Fund Name	Assets (US\$bn)	Inception Year	Source of Funds
UAE	Abu Dhabi Investment Authority	875	1976	Oil
Norway	Government Pension Fund	300	1996	Oil
Saudi Arabia	Saudi Arabian funds (various)	250+	n/a	Oil
Kuwait	Kuwait Investment Authority	250	1953	Oil
China	China Investment Corp.	200	2007	Non-commodity
Russia	Stabilisation Fund of the Russian Federation	120	2004	Oil
Singapore	Government Investment Corp.	100+	1981	Non-commodity
Singapore	Temasek Holdings	100+	1974	Non-commodity
Australia	Australia Future Fund	54	2006	Non-commodity
Qatar	Qatar Investment Authority	50	2005	Oil
Algeria	Revenue Regulation Fund	40	2000	Oil
US (Alaska)	Permanent Fund Corp.	35	1976	Oil
Brunei	Brunei General Reserve Fund	30	1983	Oil
South Korea	Korea Investment Corp.	20	2005	Non-commodity
Malaysia	Khazanah National	18	1993	Non-commodity

Source: Macquarie Research, August 2008

Five more emerging-market sovereign wealth funds are set to be launched over the next 12 months, including the first funds from Brazil, India and Thailand and additional funds from Russia and Saudi Arabia. Sovereign wealth funds from Asia and the Middle East have between

them injected \$48.3bn into troubled global investment banks in the US and Europe, excluding the most recently announced deal in which UK bank Barclays is raising funds for recapitalisation of its balance sheet from the Abu Dhabi and Qatar sovereign wealth funds. Some 46% of the \$250bn of transactions involving sovereign wealth funds between 2000 and the first quarter of 2008 were invested in financials, 19% in real estate and 11% in energy assets. With continued strong foreign-reserves accumulation expected over the next few years, the growing role and influence of emerging-market sovereign wealth funds is irreversibly changing the global financial landscape, not least because these same funds are looking to invest an increasing proportion of their assets in other emerging markets.

Asia ex Japan

While many comparisons have been drawn with Asia's financial crisis in 1997/98, emerging Asian economies today are well placed to withstand the worst of the fallout from the credit-induced economic shocks originating in the developed countries. Asia's banks today are adequately capitalised with strong balance sheets, its currency regimes more flexible, and its foreign reserves at unprecedented high levels, itself the result of many years of trade- and current-account surpluses.

Although none of Asia's emerging economies can be totally immune from the effects of the global slowdown, given their rapid integration into the world economy, what is being witnessed today is not a repeat of the economic crises in emerging-market economies in the 1990s and early years of the current decade. Growth across Asia is set to slow, however, as a result of accelerated globalisation. Even though exports to the advanced industrialised economies are still very important to Asia as a whole, they are less important than they were, reflecting successful diversification of export markets, in which China and India have become important new export markets in their own right.

The growth of emerging Asian economies increasingly is being powered by domestic drivers, with the services sector's contribution to GDP becoming much more important in the fastest-growing economies, such as China and India. Rising real disposable incomes have created new demand for housing, education, banking services and leisure time amongst many other sectors set to benefit from the ongoing expansion of the middle classes in the emerging world. While the same trends are evident across the developing world, they are most clearly visible in Asia.

Rapid industrialisation requires significant investment in physical infrastructure, such as transport and communications networks, which will itself provide strong underpinning to economic growth not only in emerging Asia, but also in the fast-expanding economies of the Middle East, Central and Eastern Europe and Latin America. Increased budgetary outlays for infrastructure investment have been a notable feature in Brazil, Russia, India and China, but the trend toward increased infrastructure spending is also apparent in the cash-rich Gulf economies and Africa.

Latin America

Among the region's larger countries, Brazil and Mexico have suffered disproportionately the fallout from the global credit crisis, with financial markets paying no attention to their successful macroeconomic stabilisation programmes. Brazil's role as a major exporter of raw materials and agricultural produce has meant that its currency, the real, has come to be viewed as a proxy for world economic growth, and therefore been unjustly punished as fears of a global economic slump have escalated. Throughout the turmoil, however, Brazil's central bank has adhered to orthodox monetary policies, while large monthly trade surpluses have continued to translate into strong foreign-reserve accumulation with the total reaching \$205.5bn in September. While trade is an important component of Brazil's economy, the prime driver of the country's strong expansion is domestic demand, growing at 8% this year, driven by a booming construction sector and housing-related activity.

Mexico, where memories of the Tequila crisis in 1994/95 are still fresh, has felt the full force of the global credit crisis, via its close linkages with North America through the 14-year old NAFTA agreement. The effects of the crisis have been seen most clearly in currency markets with the peso slumping against the dollar as investors have fretted about Mexico's high dependence on the US, both as its largest export market by far and as the source of inward remittances from Mexican migrant workers. While both Brazilian and Mexican companies have started to feel the effects of the credit squeeze, both countries have well capitalised and conservatively managed banking systems. Public finances in Brazil and Mexico are healthy and both governments are able to borrow in their own currencies, significantly reducing their dependence on dollar-denominated debt financing.

Central and Eastern Europe

Russian equities have been sold down to distressed levels, partly in response to heightened global risk aversion generally but also in response to perceptions of an increase in Russian country risk following the invasion of Georgian sovereign territory in August and increased government meddling in Russia's opaque business sector. In October, however, the full extent of markets' irrational fear about Russian country risk was reflected in a huge widening of credit default spreads on Russian government debt to a level that signalled imminent default, with Russia seen as a higher default risk than Argentina, which announced a plan to nationalise private pension funds in an effort to stave off another debt default, and Iceland, which already is in default and has secured an IMF bailout.

Backed by foreign reserves in excess of \$500bn, oil income of \$650m a day, and a sovereign debt of less than \$40bn, Russian default risk is quite clearly being mispriced under any plausible economic scenario. There is no risk of Russia defaulting on its sovereign debt. The lack of a stable domestic investor base, however, has contributed to the recent volatility in Russia's capital markets. Market participants have also been pricing in the risk of rouble devaluation, pressured by falling oil prices, but ignoring that the rouble has held up better than the euro and sterling against a resurgent US dollar, while the Central Bank of Russia is well placed to manage any further rouble depreciation. A combination of a strong dollar and weak euros, in fact, beneficial to Russia's trade performance as Russia's export revenues (energy and metals) are largely dollar-based, while imports (food and consumer goods) are largely euro-denominated. While the price of Urals crude oil, the Russian benchmark, slipped below \$60 a barrel in late October, some \$10 a barrel below the balancing figure in Russia's 2009 federal budget and equal to an estimated \$25bn of lost oil income over a full year, this would not pose a serious problem for the budget.

The Middle East

In the energy-rich Gulf Cooperation Council states, the slump in oil prices has fuelled concerns that regional economies will face a more challenging backdrop in 2009. Even allowing for the sharp fall in crude oil prices to their lowest level in more than a year, most GCC government budgets are based on an oil price of between \$45 and \$50 a barrel. Record high oil prices in the third quarter, however, which saw prices rise to over \$147 a barrel in July, are delivering another year of huge budget surpluses that GCC governments will direct into the economy, or into their stabilisation funds.

Although it is not expected that oil prices will test this year's record highs any time soon, with fears of a prolonged global recession becoming widespread, the underlying fundamentals of the oil market remain solid and will continue to put upward pressure on energy prices in the longer term. According to the International Energy Agency's annual report,

the World Energy Outlook, output from the world's oilfields is declining faster than previously thought, such that without additional investment to boost output, the natural rate of production decline is 9.1% a year. While the fall in output will not necessarily be felt over the next few years given that demand is currently weakening, the anticipated slowdown in new oilfield exploration will magnify the eventual effect on production and price levels. In the immediate future, output cuts agreed by ministers at the emergency meeting of OPEC producers in late October will provide a short-term floor for the OPEC basket of crude oils at close to the current level of \$60 a barrel, while OPEC ministers have made clear that quotas may be cut further if the decline in oil prices is not halted.

Expected lower average oil prices in 2009 compared to this year, however, will significantly ease the pressures of overheating economies, chiefly through a moderation in inflation in the Gulf economies that will translate into a moderation in cost-of-living increases that should, in turn, ease wage-inflation pressures. Expatriate workers from emerging Asian economies, particularly the Indian subcontinent, will also benefit from the weakening of their currencies against the dollar-pegged GCC currencies when remitting funds back to their home country.

With all but one of the six GCC states still operating currency pegs against the dollar, Kuwait being the only exception, this year's strong appreciation of the dollar against most world currencies, will also cut import costs, while in Kuwait which switched to a currency basket for the dinar, the currency has appreciated against the dollar since the peg was dropped in May 2007. No near-term change to the GCC dollar pegs is expected, and more likely the renewed strength of their currencies will encourage GCC central banks to leave the current exchange rate regime in place until 2010.

Global Emerging Equity Market Valuations

	2007	2008E	2009E
Argentina	14.4	4.5	3.8
Brazil	12.0	5.7	4.9
Chile	21.9	12.4	10.1
Mexico	15.5	8.2	7.7
Latin America	13.1	6.3	5.6
Czech Republic	13.6	11.0	9.5
Hungary	16.2	6.5	6.5
Poland	14.7	7.4	7.0
Russia	10.1	2.2	2.2
Turkey	10.1	3.7	3.8
Israel	14.1	10.6	9.3
South Africa	14.8	6.7	6.1
EMEA	12.3	4.4	4.1
China	20.9	8.0	7.0
India	18.8	8.9	7.2
Indonesia	14.1	7.7	7.2
South Korea	12.8	7.2	8.4
Malaysia	16.5	10.7	11.1
Philippines	18.9	11.0	9.7
Taiwan	15.6	9.6	10.4
Thailand	12.5	6.2	6.6
Emerging Asia	16.4	8.3	8.0
Global Emerging	14.4	6.6	6.2
Global	10.4	10.3	9.3
GEM discount	39%	-36%	-34%

F is forecast. Data as at October 27, 2008

Source: UBS



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Emerging Equity Markets: Valuations at Multi-year Lows

Even in the event of a global economic recession, current equity valuations in emerging markets, which expressed in terms of price/earnings ratios, are at historically low levels, are unjustified bearing no relation to economic fundamentals. Almost all emerging markets are trading at single-digit price/earnings ratios including some in low single digits. Latest data from Swiss investment bank UBS illustrate the point. In late October, global emerging-market equities were trading at a prospective 2008 price/earnings ratio of just 6.6 times (x) earnings, falling to an even more compelling 6.2 x earnings in 2009.

At that level, global emerging-market equities were trading at an abnormally high 36% discount to the global equity-market average in 2008 and an estimated 34% discount for 2009, whereas just a few months ago, the global emerging-markets average price/earnings ratio was at a small premium. Data from Securities & Investment Company (Bahrain) show all six individual GCC equity markets in late October also trading at single-digit price/earnings ratios, based on prospective 2008 earnings, and an average of 9.1x earnings for the GCC markets as a whole.

Gulf Cooperation Council Stock Market Data (as at October 27, 2008)

	Market Capitalisation US\$bn	Price/ Earnings Ratio 2008E (x)	Price/ Book Ratio 2007 (x)	Dividend Yield 2007 (%)
Saudi Arabia	282	9.8	2.1	4.1
UAE	145	8.0	1.9	2.9
Kuwait	136	8.3	1.8	4.5
Qatar	77	9.9	2.4	3.0
Bahrain	23	8.3	1.5	4.7
Oman	16	8.1	2.0	4.7
GCC total	679	9.1	2.0	3.8

Source: Securities & Investment Company (Bahrain), Central Bank of Bahrain

While in the short term, the global unwinding of previous financial excesses and ongoing deleveraging process in the developed world are set to continue and may exert further downward pressure on emerging-market equity valuations and selected emerging-market currencies, particularly in countries running unsustainable budget- and current-account deficits, on anything other than a very short-term horizon, the investment case for global emerging markets remains more compelling than for many years, given extremely oversold market conditions and the gradual maturing of emerging-market economies and capital markets.

With the 2009 outlook for corporate earnings growth, in developed and to a lesser extent in emerging markets, deteriorating and current surveys of business, consumer and investor confidence at multi-year lows, coordinated and aggressive central bank policy easing is needed to establish a solid base for global equity markets and to reinforce the stimulus from massive government pump-priming and bank recapitalisations in the developed economies. Although the 12-months global corporate earnings outlook is currently subject to greater-than-usual uncertainty, earnings growth in emerging-market economies is expected to be substantially higher than in developed markets, reflecting strong income growth, fast-expanding domestic demand and substantial scope for fiscal expansion and monetary easing, given emerging markets' generally strong public finances and improving inflation outlook.

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