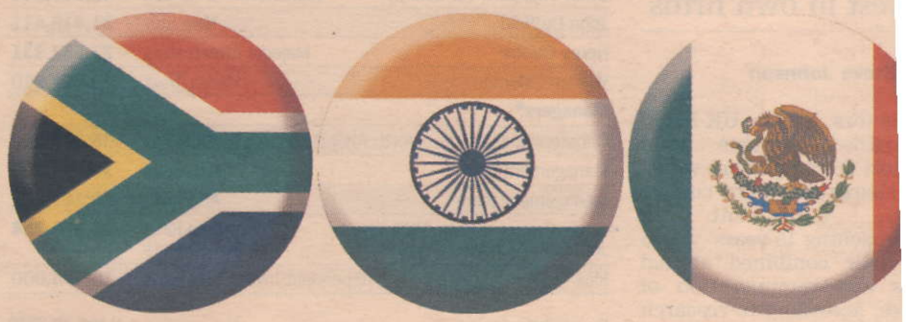
Emerging valuations raise anxiety



News analysis

Huge inflows are prompting bubble speculation, reports **Steve Johnson**

The tidal wave of cash flooding into emerging markets has pushed valuations sharply higher and is in danger of creating a bubble, according to a growing minority of commentators.

Net inflows into the developing world's equity and bond markets have totalled $1,787bn in the past decade, according to data from the Institute of International Finance.

As a result the MSCI Emerging Markets equity index has jumped 236 per cent in the past 10 years, while the S&P 500, FTSE 100 and FTSE Eurofirst 300 have all fallen, rapidly eroding the attractive relative valuation of developing world stocks.

With vast swathes of the investment industry still encouraging their clients to invest ever larger sums in emerging markets, concerns are rising that valuations could be pushed unsustainably high.

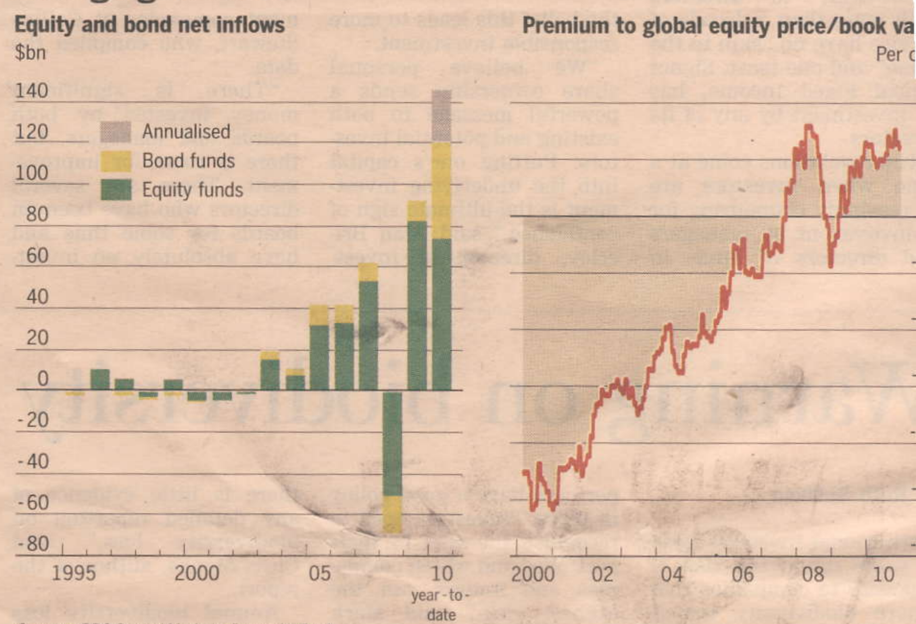
"Global emerging markets are very far from being some 'undiscovered jewel'. Those telling you to buy emerging market equities are unfortunately five to 10 years late," said Jonathan Asante, manager of the First State Global Emerging Markets Leaders Fund, part of a £25bn ($40bn) stable of developing world assets.

"The pro-emerging market consensus is worrying to us, not least because of the huge flows global emerging market equities are currently receiving. We have started to caution holders of our funds about our concerns that valuations of decent companies are generally already too high."

John-Paul Smith, strategist at Deutsche Bank, warned that a decade of outperformance had led to widespread "complacency" towards emerging markets.

"Over the past 10 years emerging equities have moved from selling at a significant discount to their developed counterparts to somewhere near parity on most measures," said Mr Smith. "Emerging debt no longer stands out as obviously cheap. Current yields leave little room for deterioration in the economic and policy-making environment in individual countries."

Jeff Molitor, chief European investment officer at Vanguard, added: "The rapid rate of growth and concentration in emerging markets warrant caution."



Sources: RBC Capital Markets; Deutsche Bank

The concerns come amid expectations that portfolio flows into emerging markets will continue unabated in 2011, amid a backdrop of sluggish economic growth in the developed world and episodes of liquidity-inducing quantitative easing.

A survey of institutional investors by Deutsche Bank found 46 per cent planned to increase their exposure to emerging market equities in the next 12 months, the highest figure for any asset class, and 26 per cent wanted more emerging market debt, with only a handful of investors planning to cut their exposure.

Barclays Capital said mutual funds' exposure to emerging markets "is beginning to look stretched", with both equity and bonds funds, in aggregate, now overweight, "reaching levels at which investors question the sustainability of the emerging market flows story going into 2011".

Capital Economics warned its clients that while valuations in emerging Asian stock markets were "reasonable" now, "bubbles will probably develop over the next months" with India a Indonesia most vulnerabl

Ariel Bezalel, manager the Jupiter Strategic Bo Fund, argued that, wh some parts of the emergi world still offered val "we can see a bubble spreads [over US Treas ies] go much tighter".

Mr Smith added: "Wh there is a strong consens on any asset class, it often a sign the econor cycle is about to move the other direction."

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