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Volatility In Emerging Markets: A Warning Sign

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On Feb. 13, *Inside Global Markets* cautioned subscribers about an upcoming correction in emerging market securities. With many of these stock markets having experienced tremendous price appreciation since the start of 2003--iShares MSCI Mexico Index is up over 300%, Templeton Russia & East Europe Fund has climbed about 275%, India Fund has returned nearly 300% and iShares MSCI Brazil Index is up over 500%--it was our view that risks were nearing the breaking point.

Among the many reasons we have been concerned:

Heavy investor inflows into international equities, especially emerging market assets. In the past few years, U.S. investors have significantly increased their exposure to equity markets around the world, while reducing positions in U.S. stocks. During 2005, Americans shoveled a net $104.6 billion into international funds, compared to just $31.2 billion allocated to domestic funds. And in 2006, *an amazing 92.5% of all U.S. equity mutual fund net inflows went into international stocks*--$148.6 billion, versus a mere $12.1 billion of net new capital allocated to domestic funds. In our view, these numbers were very reminiscent of the fund flows seen in technology and aggressive growth funds in early 2000.

Prospects that the tremendous price appreciation since 2003 already reflects fundamental improvements in these economies. There is no doubt that fundamentals for emerging market economies have improved dramatically during the course of the past few years. Countries such as China (take a look at the iShares FTSE/Xinhua China 25 Index) and Brazil boast substantial current account surpluses, larger foreign currency reserves, undervalued currencies and stable inflation rates. What is more, the major developing nations have growing middle classes and rising levels of household wealth, trends that are fueling domestic consumption. It all sounds good, but we questioned the extent to which these fundamental changes were sustainable (as opposed to "one-off" events) and whether these improvements were already largely priced in.

Jitters related to a cyclical downturn in economic growth (especially in the U.S.). There is growing evidence that the U.S. economy slowed substantially in the first quarter of 2007. In January, the ISM manufacturing Index fell below 50, the lowest reading for this survey of U.S. manufacturing conditions since April 2003. Of even greater significance has been the one-two punch of disappointing housing data and an outpouring of bad news from the subprime mortgage market. And January U.S. retail sales figures came in lower than expected, perhaps a sign of things to come. A sustained downturn in U.S. economic activity would likely place pressure on emerging market equities (though emerging market currencies and interest rates could very well outperform).

Trend for weaker commodity prices. As we observed in the Jan. 18, 2007, issue of Inside Global Markets, "What to do About Oil," the CRB commodity index has already broken below a four-year uptrend, and though prices have bounced off the recent lows, historical precedent reveals that except for relatively infrequent and short-lived price spikes, commodity prices in general have declined in real terms for as long as there have been data to track them. The potential for a sustained downtrend in commodities could be critical to the outlook for emerging market equities given the correlation in recent years. And if U.S. growth slows, as recent data suggests, the probability of weaker commodity prices climbs substantially.

Worsening outlook for global liquidity. Arguably the most important factor behind the tremendous gains seen in both the commodities and emerging market securities during the past several years has been the combination of abundant global liquidity and historically low real interest rates, which has not only helped fuel massive inflows into riskier asset classes, but also has allowed emerging markets to slash borrowing costs and refinance debt. In the past, interest rate hikes by the world's central bankers have almost always adversely affected emerging market investment flows (as was seen in 1994, 1997 and 2000), but that has not been the case this time around ... at least not yet.

There are many explanations offered for the continuation of plentiful "liquidity" conditions: petrodollar liquidity (surplus savings of commodity producers); Asian country trade surpluses (China's foreign currency reserves recently exceeded $1 trillion); the "carry trade" (borrowing in countries with low interest rates, primarily Japan and Switzerland, and investing in countries with higher yields); the growth of derivatives markets, which permit investors to gain access to capital outside the banking system (thus, the Fed and other central bankers have less of an ability to control lending); and the growth of alternative investments (including hedge funds and private equity vehicles). It seems everyone has a theory.

But regardless of one's view on the various possible sources of liquidity, such benign conditions are not guaranteed to last forever. In fact, the liquidity tailwinds of the past few years could quickly turn into strong headwinds for global stocks markets, with emerging market equities likely to bear the brunt of the adjustment.

Our recommendation was to buy put options on the i-Shares MSCI Emerging Market Index. At the time, the actual volatility (i.e., historical volatility) of EEM options over the course of the past year was approximately 26, while the implied volatility (i.e., the volatility currently priced into the option price) was approximately 27. Given the substantial price appreciation of emerging market equities during the course of the past few years, we view paying average volatility for the option as a relative bargain.

On Feb. 27, markets experienced a substantial correction, and emerging market stocks fell across the board. The iShares MSCI Emerging Market Index fell from 117.50 to an intraday low of approximately 105, a one-day decline of almost 11%. The put options recommended by Inside Global Markets on Feb. 13 appreciated more than 100%.

What to Do Now?

We have still not recommended that our subscribers take profits. Markets seldom experience volatility in isolation and the wild market swings on March 1 (Dow started the day down over 200 points before reaching positive territory intraday) tend to confirm that point.

Investors who have piled into emerging market stocks need to have a good understanding of the many complexities and risks associated with investing in international equity markets:

--Unlike domestic equity strategies, international equity investing involves exposure to foreign exchange risk (the impact of which can be very significant).

--International equities are exposed to a wide array of geopolitical, cultural and trade risks

--Local markets for international equities often trade very differently than ETFs, ADRs or other representative securities.

--International equities are heavily influenced not only by local policymakers, but also by the policies of the world's major central banks, such as the Bank of Japan and the U.S. Federal Reserve.

--Many international markets are heavily reliant on commodity prices or are highly correlated to a specific sector, such as telecom.

Recently, emerging market equities and developed market equities have traded in similar patterns--exhibiting signs of positive correlation. There is no guarantee this will continue.

We will continue to explain to subscribers of Inside Global Markets how they can best prepare for the uncertainties associated with investing in global equity markets.

Excerpted from the Feb. 13 issue of *Inside Global Markets*, which includes expanded analysis and a recommended trading opportunity. Click here for more information about *Inside Global Markets* and subscription details.

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