Emerging Market Growing Pains

Over the last several decades, investing in emerging markets has grown from a niche play for highly specialized institutional investors to an integral part of a globally diversified portfolio. Booming population growth and increasing globalization have helped propel emerging market countries into a significant position in the world economy. Since 1988, the market capitalization of emerging market stocks (float-adjusted) has grown from 1% of the world stock market to nearly 10% of markets today. According to the International Monetary Fund, China alone contributed 20% of the world's GDP growth in 2007. As growth rates in developed nations like the U.S. and the U.K. slow in 2008, we expect China and other emerging markets to become an even greater share of global growth.

"Generation EM"

Much of the strength of the global secular bull market of the last 25 years can be attributed to advances in technology and the ensuing productivity gains. Teenagers today take for granted the overwhelming accessibility of computers, email and cell phones in our society. Many would be surprised to find out that even 10 years ago it was impossible to carry around an entire music library in our pockets, and most of us had to go home to check our phone messages. Imagine how much faster, and more advanced, our learning and development would have been with the benefit of the innovations available at our fingertips today.

Emerging Markets are the world's teenagers. They are certainly not as mature, savvy or capitalized as their developed counterparts, but their room to grow is tremendous. They are coming of age in the most globalized economy in history, and they have an enormous, educated workforce ready to reap the benefits of today's advanced technological backdrop. The China Internet Network Information Center estimates that China recently has surpassed the U.S. in the largest number of internet users in the world, with a figure in excess of 210 million at the end of 2007. These countries also are prioritizing home-grown innovation. The Chinese government released its *Medium- and Long-Term Plan for the Development of Science and Technology (2006-2020)* in early 2006, with the goal of turning China into an innovative nation by 2020. It includes lofty goals such as:

- Investing 2.5% of its growing gross domestic product in R&D;
- Increasing contributions from technological advance to more than 60% of economic growth;
- Limiting dependence on imported technology; and
- Becoming one of the top five countries in the world in the number of invention patents granted to Chinese citizens and in the number of citations to Chinese-authored scientific papers.

The Growth Spurt

Demographics alone are a powerful force. China and India together account for 37% of the world's population. Current growth rates imply that ***every day*** there are an additional 50,000 Indian people on the planet. By comparison, the U.S. accounts for less than 5% of the global population. The emergence of an urbanized middle class society in these countries is fueling tremendous demand for infrastructure, including roads, airports, railways, and hospitals. In 2007, foreign investment in India doubled, hitting a record $17 billion. This feedback loop provides capital for domestic growth; enhances the wealth of emerging populations and companies; stimulates demand for high-skill exports from developed nations; which in turn aids in the further development of these burgeoning economies.

Top 20 Countries Ranked by Population

Rank	Country	Population*	% of World Total
1	**China**	1,321,851,888	20.0%
2	**India**	1,129,866,154	17.1%
3	U.S.A.	301,139,947	4.6%
4	Indonesia	234,693,997	3.6%
5	**Brazil**	190,010,647	2.9%
6	Pakistan	164,741,924	2.5%
7	Bangladesh	150,448,339	2.3%
8	**Russia**	141,377,752	2.1%
9	Nigeria	135,031,164	2.0%
10	Japan	127,433,494	1.9%
11	Mexico	108,700,891	1.6%
12	Philippines	91,077,287	1.4%
13	Vietnam	85,262,356	1.3%
14	Germany	82,400,996	1.2%
15	Egypt	80,335,036	1.2%
16	Ethiopia	76,511,887	1.2%
17	Turkey	71,158,647	1.1%
18	Congo	65,751,512	1.0%
19	Iran	65,397,521	1.0%
20	Thailand	65,068,149	1.0%
	World	**6,602,224,175**	

Source: Estimates from "The World Factbook 2006-2007", CIA, GeoHive.com

* As of 7/1/2007

Part of the "In" Crowd

Even anecdotal evidence shows the growing role of emerging countries in the world economy. The newly-appointed Chief Economist of the World Bank is Justin Lin, a Taiwan-born Chinese citizen, and current head of the China Center for Economic Research at Peking University. He will be the first person to fill this role who hails from outside either the U.S. or Europe. Robert Zoellick, head of the Washington-based World Bank, stated, "As our first chief economist from a developing country, and an expert on economic development and particularly agriculture, Justin Lin brings a unique set of skills and experience to the World Bank Group." Firsts such as this for the emerging world highlight the importance of developing countries in the next phase of world economic development.

Demanding

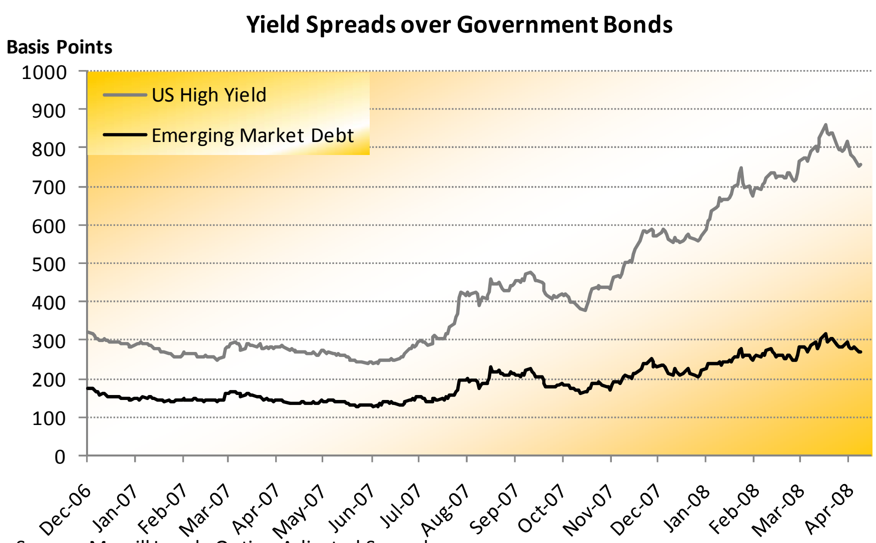
The impact of the emerging world's growth on global supply and demand dynamics is dramatic. As we have seen recently, commodities such as food and oil are extremely sensitive to growing demand pressures (please see our March 14, 2008 research publication "What Does It Mean To Be Defensive?" for more about our view on commodities). Long-term trends are helping to boost oil prices to record highs.

According to OPEC, world demand for crude oil rose by 1.4% in 2007 despite the fact that developed nations actually reduced consumption. OPEC projections expect world demand for crude to rise an additional 1.3 million barrels per day in 2008, with non-OECD countries (developing nations) accounting for about 80% of the total. They expect China alone to be responsible for 30% of the growth. Demand is also growing in so called “frontier markets” in the Middle East. In the past 10 years, approximately 75% of increased production from oil-producing countries stayed in the region, fueling domestic growth.

As these countries grow richer, traditional eastern diets are evolving to include more western staples, such as meat. Instead of a shift in diet reducing demand for agricultural commodities, it will actually put more pressure on these resources. For example, it requires about 700 calories worth of animal feed to produce 100 calories worth of beef, while more energy-based fertilizer supplies will also be required to supply the feed. A recent World Bank report states that global food prices have risen 83% in the last three years. As we have seen with the current crisis in the supply of rice, this issue is extremely important for continued growth in developing regions. While these trends support higher commodity prices in the medium-term, a positive trend for commodity rich countries like Russia and Brazil, it is an area of concern for sustained development. On the upside, the problem should attract attention and resources from world organizations, which could enhance the infrastructure necessary for lesser-developed frontier markets to make the leap toward emerging markets. In response to the rising food prices, the World Bank says, "We must make agriculture a priority. The Bank has announced it will double agriculture lending for sub-Saharan Africa over the next year from $450 million to $800 million. IFC (International Finance Corporation) will be boosting its agribusiness investments, too, across the value chain of production.”

Staying Out of Trouble

With many structural tailwinds, emerging market nations are on a long-term path for growth. In the midst of a slowdown in the U.S., emerging economies have remained remarkably resilient. Despite pronounced risk aversion in western markets, the spreads on emerging market debt have not widened considerably. The balance sheets of these countries have improved dramatically in recent years, and many no longer run current account deficits. Furthermore, the subprime losses that triggered the crisis in the U.S. are largely



Source: Merrill Lynch, Option Adjusted Spread absent from emerging market companies.

The IMF estimates that Russia, India and China can expect GDP growth of 7%-9 % in the next several years, while the G7 countries will likely grow only 0.5%-2%. Strength in world demand for commodities is important support for Russia, Brazil and other Latin American countries rich in natural resources. Interest rates are low by historical standards, and the hyperinflation that crippled countries like Brazil in past decades is unlikely to return. Nevertheless, accelerating inflation is worrisome, both in emerging countries and in the developed nations importing these rising costs. The slowing U.S. economy has mitigated global inflation pressures; however, the fiscal and monetary stimulus actions taken by U.S. policy makers should begin to reinvigorate the American consumer in the next few quarters. At that point, inflation could become a more serious issue impacting sustained economic growth.

Annual Inflation Rates						
	1980	1985	1990	1995	2000	2007
Brazil	132.6%	226.0%	2947.7%	66.0%	7.1%	3.6%
China	6.0%	9.3%	3.1%	17.1%	0.4%	4.8%
India	11.4%	5.6%	9.0%	10.2%	4.0%	6.4%
Russia	N/A	N/A	N/A	197.5%	20.8%	9.0%

Source: IMF World Economic Outlook Database, April 2008

Peer Pressure

Despite underlying strength in emerging economies, equity markets have suffered alongside their developed nation counterparts. The MSCI EM Index fell -17% in the five months ending March 2008, while the MSCI BRIC Index (Brazil, Russia, India, China) fell almost -21% in the same period. For U.S. based investors, these losses were cushioned by the falling dollar; in euro terms, the indices fell an additional 6%-7%.

Index Total Returns			
	S&P 500	MSCI EM	MSCI BRIC
2005	4.9%	34.0%	44.2%
2006	15.8%	32.2%	56.4%
2007	5.5%	39.4%	58.9%
As of March 31, 2008			
Trailing 5 Months	-13.5%	-17.0%	-20.7%
Trailing 12 Months	-4.7%	21.3%	33.2%

This correction was not driven by a fundamental emerging markets problem, but by fears of a U.S. recession. After consecutive years of extraordinary gains and concerns about overheated valuations, a technical pullback was likely warranted. Even with the losses of the past five months, the trailing 1-year gains are 21% and 33% in the MSCI EM and MSCI BRIC indices, respectively.

A Bright Future

Like teenagers going through an awkward stage, there undoubtedly will be some bumps in the road. Emerging markets are not immune to what happens in the global economy, and still tend to exhibit more volatility than developed markets. But we believe that the long-term fundamentals are in place for tremendous growth and innovation. Major players like China probably will grow less quickly given a slowdown in the U.S., but exports are no longer the only source of demand for emerging markets' goods. A strong cycle of domestic demand, as well as trade with other non-western nations, should help sustain growth in the short term. We expect further market volatility and periodic corrections, especially as valuations get expensive. The key is to stay invested and diversified, and avoid trying to time the ups and downs.

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