WHAT'S DEVELOPING

INVESTING IN EMERGING MARKETS

APRIL 2013

BLACKROCK®

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What Is Inside

SO WHAT DO I DO WITH MY MONEY?™

- **Beware Fake Goods:** Emerging market exposures come in many guises. Carefully examine the goods before purchase.
- **Warning Flags:** Steer away from countries and assets that rely on external funding or show signs of excessive credit growth.
- **Next Frontier:** Frontier markets offer compelling stock valuations, comparatively high bond yields and low volatility ... but few investable assets.

Debt (details on pages 12–14)

- **Relative Value:** Emerging market bonds offer relatively high yields in the zero rate world—but it will be tough to replicate the double-digit returns of the past.
- **Captive Demand:** Explosive growth in emerging market pension assets underpins structural demand for emerging debt.
- **Big Is Beautiful:** Emerging debt markets have jumped in size, credit quality and diversity. This means more opportunities to separate the wheat from the chaff.

Equities (details on pages 15–16)

- **Cash Is King:** We like companies that derive a large proportion of their cash flow from emerging markets—wherever they may be listed. If they increase dividends, all the better.
- **Travel Destinations:** Brazilian and Russian stocks look like good value after underperformance. We would avoid the Mexican and Shanghai bourses for now.
- **Foodies Welcome:** Increased global demand for food bodes well for companies specializing in agricultural equipment, food science and logistics.

(detailed investment ideas on page 19)

The opinions expressed are as of April 2013 and may change as subsequent conditions vary.

First Words and Summary

Perhaps the label "emerging markets" has outlived its use.

First, disparities among economies, cultures and development in the emerging world are huge. These disparities are becoming ever greater as economies and financial markets mature at a very different pace.

Second, some developed nations display behaviors we used to ascribe to emerging markets: profligate spending, markets run by government *diktat* and bailouts where political convenience overwhelms financial good sense. These days, financial crises are likely to erupt in the developed world.

We offer three overarching ideas on exposures, investments and risks (see sidebar below). Other highlights include:

The world will likely be able to feed itself, but many countries will lose food self-sufficiency. This will create opportunities in agricultural equipment, technology, science and logistics. A lower energy price helps this investment case. Brace for increased conflicts over land and water.

Emerging markets are rapidly catching up to the developed world. High economic growth, however, is no guarantee for high financial returns—especially not in equities. China's rebalancing its economy is a risk, as the country has been the driver of burgeoning intra-emerging markets trade.

Credit expansion at multiples of nominal economic growth is a warning sign. By this measure Turkey, Indonesia and China appear troubled. Our rule of thumb: Acceleration of credit growth + high foreign ownership of assets = red flag.

3 EMERGED INSIGHTS

1 BASICS

Choosing the right emerging market exposure (and there are many) is becoming even more important. Disparities among countries, cities and companies are growing fast—and so are disparities among returns.

2 INVESTMENTS

Emerging debt is still attractive in a richly valued fixed income world—but will likely disappoint those used to double-digit annual returns. For equities, the key is to focus on companies that generate cash flow in favored geographies.

3 RISKS

The waning of US quantitative easing or a stronger US dollar could spell trouble for emerging markets relying on external funding—especially for those countries that have seen recent credit booms.

It would be quite a coup to come up with a new phraseology that better reflects the current state of affairs—suggestions are gratefully received.

For now though, we recognize investors are familiar with the terms "emerging" and "developed"—and likely have lost their appetite for additional jargon or cute acronyms.

What are the main long-term factors in investing in this part of the world? These include the different types of emerging market exposures; the deepening of financial markets; urbanization; China's shift to a consumption-driven economy; and the increasing global appetite for food (and fresh water).

After discussing these trends, we identify investment opportunities—and perils—in emerging market debt and equity. We conclude by highlighting two risks as the era of easy money draws to a close: a strong US dollar and credit booms.

Emerging economies are aging. This leads to the need for funded pensions, and heralds a shift in global financial markets. Assets are scarce—and, therefore, emerging debt securities are liable to remain expensive. And demand for emerging market alternative assets could rise.

Growth in domestic savings lessens the emerging world's reliance on external funding. Even so, a strong dollar has never been a boon for emerging market investors—and this piece of financial physics may resurface again.

BLACKROCK'S EMERGING MARKET FORUM

Around 50 BlackRock portfolio managers discussed emerging market trends and exchanged views with a dozen external experts during a two-day event organized by the BlackRock Investment Institute in March 2013. This publication captures the highlights.

Emerging Exposures: Basics

Emerging market investors face a plethora of labels and acronyms: BRICs (Brazil, Russia, India and China), BRICS (BRICs plus South Africa), MIST (Mexico, Indonesia, South Korea and Turkey), and frontier markets.

Labels may be handy but do not tell the whole story. It starts with understanding exactly what goes into benchmark indices. See the chart below. This is basic—but may surprise all the same. Consider:

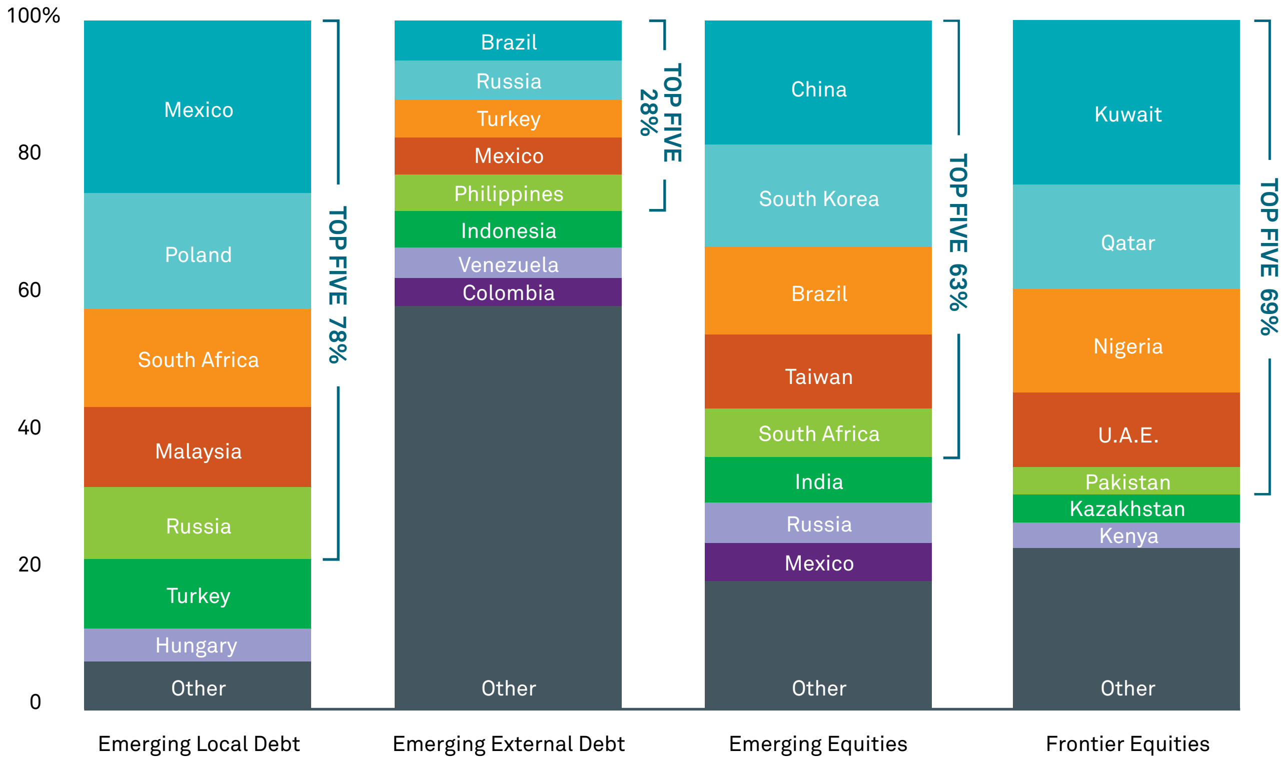
- China, the world's second-largest economy, has a featherlight weighting in debt indices. It basically does not show. This is due to both a lack of external debt and investable local currency bonds. The country does have a sizable 18% equity weighting. See the chart's third bar.
- Five countries dominate emerging local debt markets with a combined 78% weighting. By contrast, the benchmark diversified external debt index is a potpourri of countries with the top five making up less than a third. See the chart's first and second bars.
- Frontier markets may conjure up images of supercharged growth (and matching risks) in Vietnam and sub-Saharan Africa. Instead, three Gulf nations make up about half of the benchmark index. See the chart's fourth bar.

Emerging market exposures are not necessarily in emerging markets. Companies are increasingly global, and their organizational structures reflect this. A company's financial listing may be in one place, corporate headquarters in another, production and sales elsewhere and its legal home yet someplace else.

Luxury goods makers with US, UK and Paris listings are de-facto emerging market stocks, as the majority of their business comes from there. Prada and others have recognized this explicitly by establishing primary listings near their main customers in Hong Kong.

LOOKING UNDER THE INDEX HOOD

Emerging Market Index Country Weightings



Sources: J.P. Morgan and MSCI, April 2013.
Notes: Emerging local debt is represented by the J.P. Morgan GBI-EM Index; emerging external debt by the J.P. Morgan EMBI Diversified Index; emerging equities by the MSCI Emerging Equities Index; and frontier markets by the MSCI Frontier Markets Index.

Many emerging market stocks, by contrast, are as fake as designer handbags sold on street corners.

India's outsourcing companies generate most of their business from US and European clients, and Samsung Electronics is clearly more a global than a South Korean business.

Emerging market exposure of developed industry sectors changes over time—whereas their weightings in benchmark indices does not. See the charts below.

The left charts show the top quintile of stocks most susceptible to moves in the broad emerging market index by industry sector, while the right charts show the sectors' (static) weightings in developed benchmark indices in the period 2010–2012.

This means investors in developed world stocks may be more- or less-exposed to emerging markets than they realize.

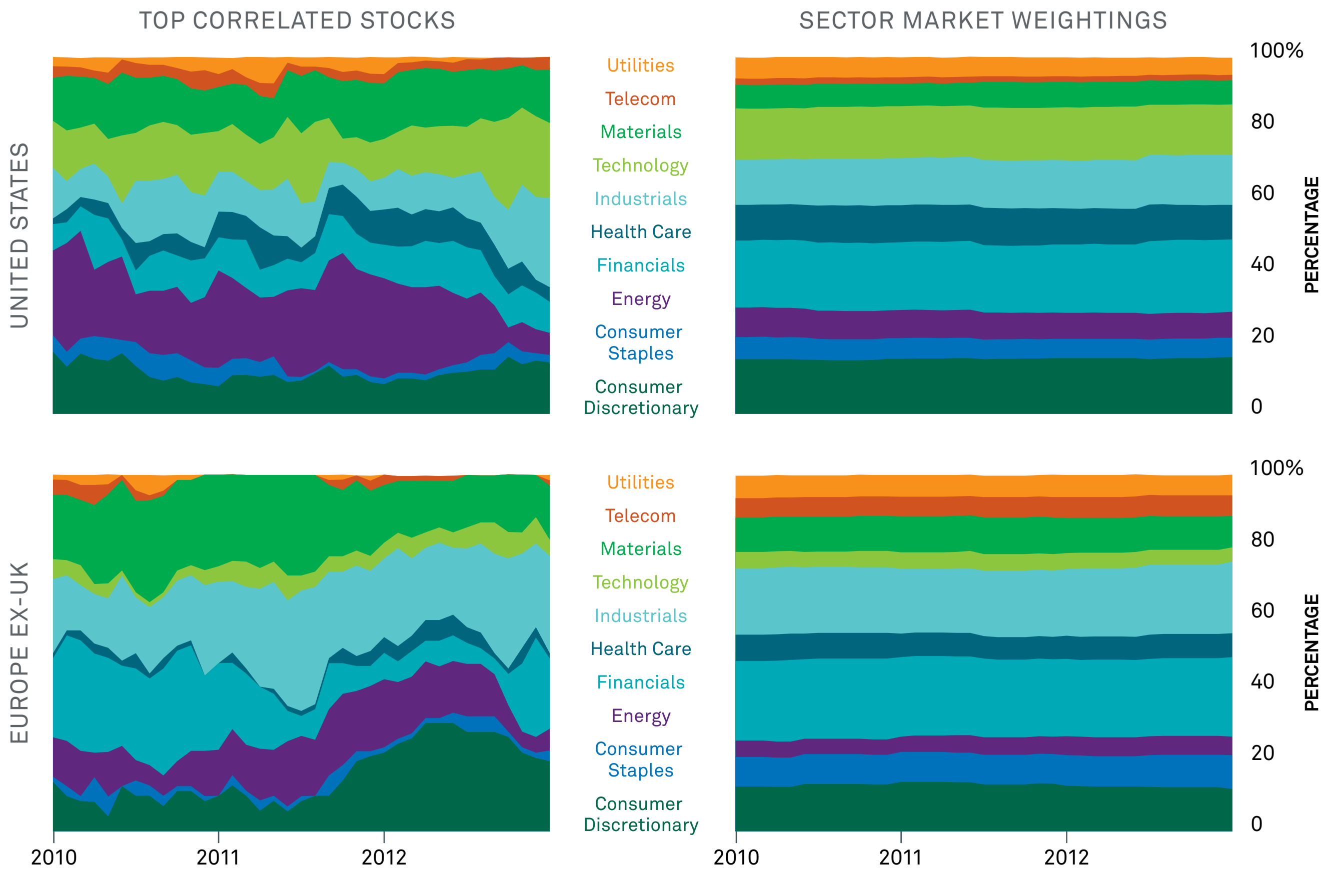
For example, the top stocks with emerging market exposure in both the US and European markets were often found in the energy sector throughout the period shown—until the third quarter of 2012. They then lost more than half of their exposure, bringing them in line with their benchmark weightings. See the purple areas in the charts below.

One way to uncover pure emerging market exposure is to crunch the numbers on where a company generates its sales. Better (but tougher) yet is to calculate where the company generates most of its cash flow. Then use its funding source (typically its financial home) as the appropriate discount rate.

Bottom line: Use labels but do your homework. Differences across emerging markets will only increase as they gain a larger share of the world economy. This calls for a nuanced investment strategy, as highlighted in *Emerging Markets: There's More Than One Way to Play* by BlackRock's Global Allocation team in April 2013.

SHIFTING SANDS

Developed Market Stocks Most Exposed to Emerging Markets, 2010–2012



Sources: BlackRock and MSCI, April 2013.
Notes: Emerging exposure for each industry sector is the regression of rolling weekly returns on the appropriate developed market index and MSCI Emerging Markets Index to identify the top quintile of equities with the most indirect exposure to emerging markets.

Mind the Gap: Deeper Markets

The emerging world's share of the global pie is growing—but it has a long way to go, especially in financial assets.

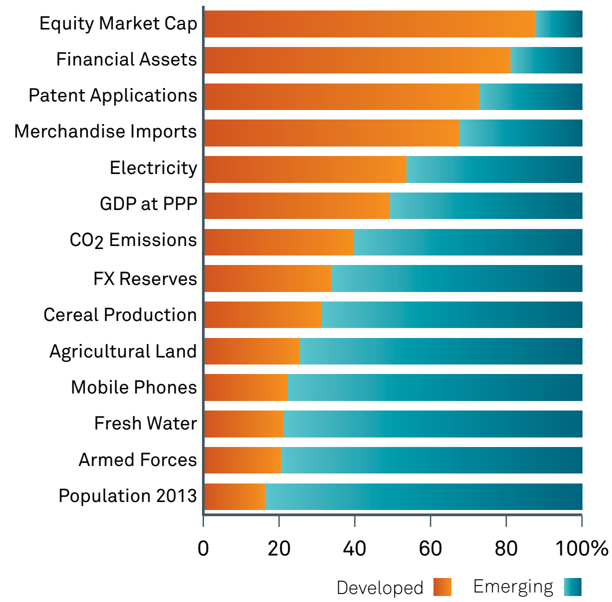
The total free-float market capitalization of all emerging stocks is just one-eighth of the global total, for example. See the chart on the right.

Developed nations still hold an overwhelming share of the world's financial assets. The United States, Europe and Japan held a total of $138 trillion at the end of 2010, compared with $40 trillion for emerging markets. See the top table below.

The *growth* in assets, however, is faster in emerging markets. See the bottom table below. Ignore the explosive growth of the developed world's central bank balance sheets. This is not necessarily a good thing and may not last—although the Bank of Japan (BoJ) is planning to give it another boost.

CUTTING THE GLOBAL PIE

Developed vs. Emerging Markets



Sources: IMF, World Bank, McKinsey Global Institute and MSCI.
Notes: Electricity is electricity consumption. Armed forces are measured by number of military personnel.

Click for interactive country data

HAVES AND SOON-TO-HAVES

Global Financial Assets and Compound Annual Growth Rates, 2000–2010

Developed Markets Hold the Assets ... (TRILLIONS)

		United States	Western Europe	Japan	China	Other Asia	Latin America	Middle East & North Africa
HOUSEHOLDS		$27	$23	$11.6	$6.5	$3.5	$3.5	$2.7
INSTITUTIONS	Pension Funds	$15	$5.3	$3.3	$0.5	$0.7	$0.7	$0.4
	Insurers	$6.6	$9.6	$3.5	$0.6	$0.3	$0.3	$0.1
COMPANIES	Banks	$4	$11.9	$6.7	$3.9	$0.9	$0.9	$0.5
	Non-Financials	$2	$1.7	$1.2	$3.8	$1.3	$0.3	$0.2
GOVERNMENTS	Central Banks	$2.3	$1.7	$1	$2.5	$1.9	$0.5	$0.4
	SWFs	$0.1	$0.6		$0.7	$0.9	$0.1	$1.7

... But Growth Is in Emerging Markets

		United States	Western Europe	Japan	China	Other Asia	Latin America	Middle East & North Africa
HOUSEHOLDS		3.9%	2.9%	0.6%	16.2%	10%	15.6%	22.8%
INSTITUTIONS	Pension Funds	4.1%	5.2%	6.8%	27.3%	19.4%	24%	14%
	Insurers	5.1%	4.4%	2.6%	30%	18.9%	21.7%	15.5%
COMPANIES	Banks	5%	7.4%	7.1%	20%	14.3%	13.7%	20.7%
	Non-Financials	9.2%	3.4%	2.9%	10.4%	15.5%	18.2%	18.7%
GOVERNMENTS	Central Banks	37%	18.7%	11.6%	6.5%	8.1%	12.6%	22.6%
	SWFs		9%		3.6%		20.4%	12%

Source: McKinsey Global Institute, December 2011.
Notes: Global financial assets held by residents at the end of 2010. SWFs are sovereign wealth funds.

The growth is essentially groundhog day. China and India accounted for almost half of the world's output in 1820. After a decline that bottomed in the 1950s, their combined share of global output is expected to rise to almost 40% by 2030, according to the Organisation for Economic Co-operation and Development (OECD).

Some key numbers from J.P. Morgan and McKinsey show the present and (possible) future. Emerging markets:

- Contribute 70% of global economic growth, with China alone accounting for 50%.
- Account for 40% of global consumption—nearly double the US share.
- Are expected to have twice as many middle- and upper-income households as the developed world by 2025.

The assets of emerging market sovereign wealth funds, insurers and pension funds have exploded, providing a major source of domestic (and global) demand. Total pension and insurance assets more than doubled to $4.5 trillion between 2005 and 2011, according to J.P. Morgan, and look poised for more growth.

Yet overall, emerging market financial assets have not kept up with robust economic growth, according to McKinsey. The emerging world accounted for 38% of global GDP in 2012, but just 19% of financial assets—a gap of 19 percentage points. In fact, this gap widened from 13 percentage points in 2007, according to McKinsey.

The United States and Japan, for example, have financial assets around 450% of GDP, while China has half that number, according to McKinsey. See the chart below.

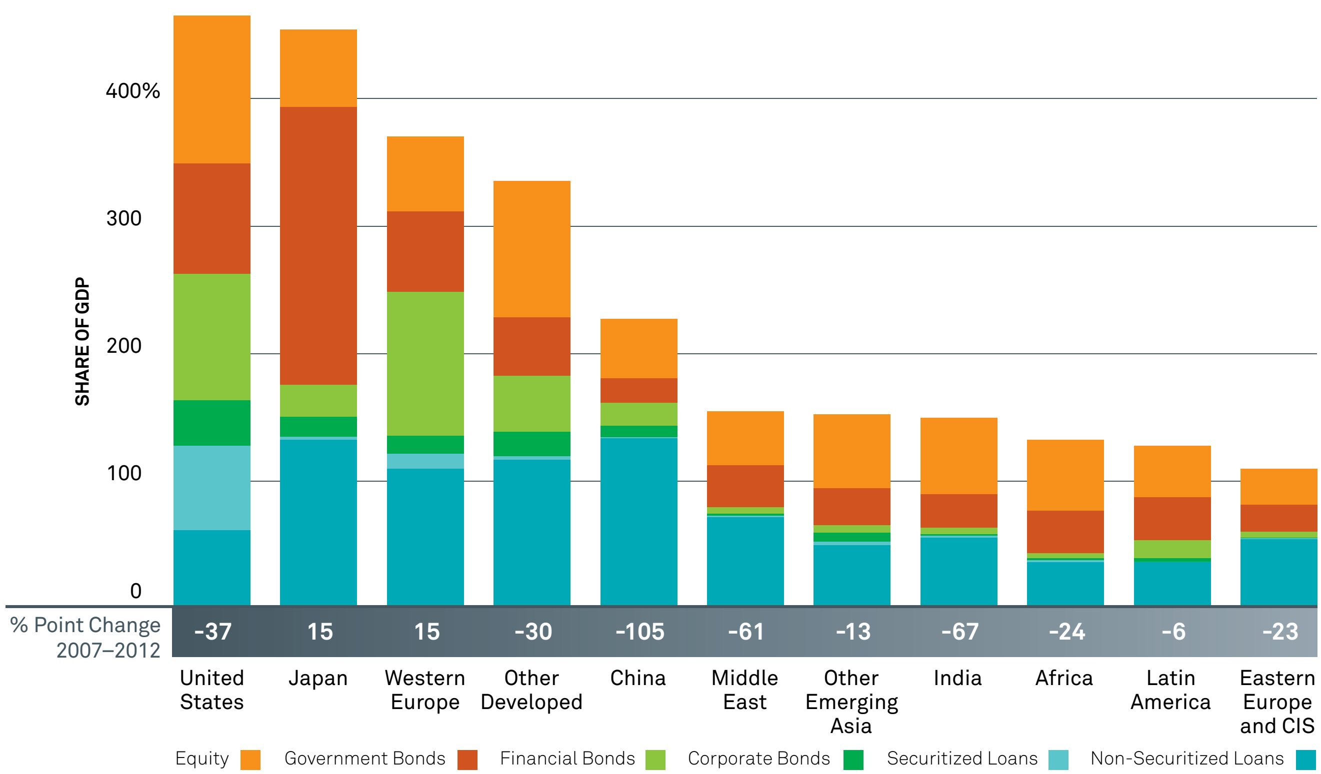
Two counterpoints:

1. The developed world's government debt load magnifies its financial market depth by this measure. Japan is a prime example. See the second bar in the chart.
2. The size, accessibility and diversity of emerging debt and equity markets have increased significantly.

Financial development is joined at the hip with GDP growth. The richer countries are, the higher they score on a financial development scale of the World Economic Forum. There are outliers. Some Gulf nations have comparatively low scores whereas poorer countries such as China and South Africa score relatively high.

OUT OF FINANCIAL DEPTH?

Financial Assets to GDP, 2012



Source: McKinsey Global Institute.
Notes: Financial depth is a region's total outstanding debt and equity as a percentage of GDP. Data as of the second quarter of 2012.

The City Beckons: Urbanization

Economies expand in tandem with cities, history shows. This is because urbanization unleashes a spurt in productivity by pulling people out of subsistence farming. The world's two biggest nations, China and India, are still in early stages of urbanization, as the chart below shows.

Fast-growing nations such as Nigeria are coming off a similarly low base. Conclusion: We have only seen the tip of the iceberg of emerging market growth.

Countries with a focus on infrastructure and planning get the biggest economic boost, but even nations with more haphazard urbanization notch sizable rises in productivity, according to McKinsey.

Urbanization is expected to boost the world's consuming class (people with income of $10 a day or more) by 1.8 billion to 4.2 billion people in 2025, according to McKinsey. The emerging middle class (households with annual incomes of $20,000 or more) should reach 617 million by then, almost double the developed world's, the firm expects.

The largest 440 emerging market cities by GDP will drive almost half of global growth by 2025, the firm estimates. It makes sense to focus on cities rather than countries. For example, the firm expects sales growth of laundry detergents in Sao Paulo to exceed Poland's in the next 10 years (in absolute dollars). Bangkok consumers are expected to increase spending on detergents by as much as the whole of France in the period.

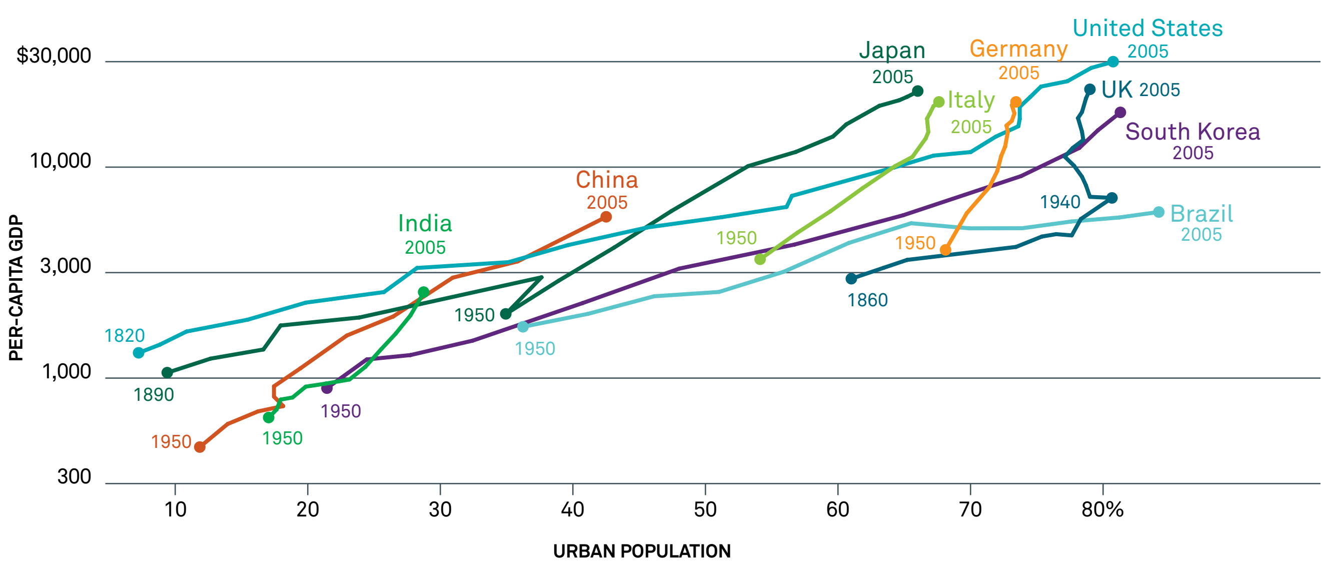
Economic growth typically triggers widening income gaps—which then level off with the growth of a middle class. At least, this is what many textbooks say. In fact, income inequality has been growing in most industrialized nations since the 1980s, according to a 2011 OECD study. This is a potential source for social instability.

In the emerging world, South Africa, Thailand and Colombia have some of the biggest income gaps, according to the World Bank and *CIA World Factbook*. The disparities go some way toward explaining Thailand's rural-urban political divide and South Africa's social tensions.

China's inequality is approaching Brazil's. This is a Great Leap (but not necessarily one forward) from the era before China opened up more than three decades ago. Beijing recognizes this dichotomy and seeks to keep a lid on discord by stamping on excessive real estate price appreciation and dedicating much of the 12th Five Year Plan to programs in health, education and social infrastructure.

STRIKING IT RICH IN THE CITY

GDP and Urbanization Trends, 1820–2005



Source: McKinsey Global Institute.
Notes: The definition of urbanization varies by country. The pre-1950 UK figures are estimated. Per-capita GDP figures are on a log scale and expressed in 1990 Geary-Khamis dollars, which reflect purchasing power parity.

Plentiful But Wasted: Food

Will the world be able to feed itself? Most experts think so—even though it is challenging with rising populations, incomes and temperatures.

The problem—and opportunity—is that food often is not in the right place. This means there is an opportunity in food logistics, from bulk shipping to packaging and refrigeration techniques.

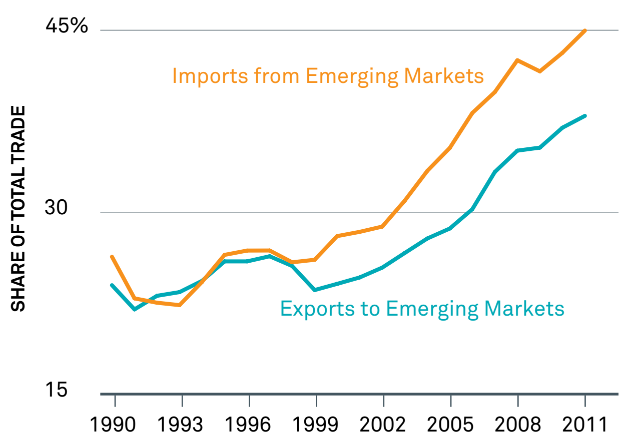
This is an old investment theme. The Greek and Roman empires both sought food security and invested in maritime capabilities to ensure speedy and consistent deliveries. Britain's naval history was bolstered by similar themes, including a loss of domestic food self-sufficiency and a rise in pollution—see Charles Dickens for details.

Today, China is investing heavily in Latin America and Africa. The fastest-growing trade routes in the world are between the Southern Hemisphere and East Asia. This does come at the (understandable) price of increased political tensions between China and its neighbors over marine routes and rights.

Many dry bulk shippers currently suffer from overcapacity as a result of the 2006–2008 ship building binge. Growing volumes may absorb this surplus, and the benchmark Baltic Dry Index could reflect this over the next year. Ports are capital-intensive and low-return businesses, but we think they offer some inflation protection and are likely to see volume growth in emerging economies.

EMERGING TRADE WEB

Trade Flows Within Emerging Markets, 1990–2011



Source: IMF Direction of Trade Statistics. Data through June 30, 2011.

Food and resources have been driving trade between emerging markets. Just two decades ago, the vast majority of emerging market trade was still with the developed world. Now, close to half of imports are from other emerging markets. See the chart below.

Global food demand is underpinned by three structural demand factors:

1. Population growth: The world's population is expected to grow 30% to 9 billion in 2050, according to a 2011 UN population study.
2. Changing diets: Rising incomes mean rising meat and dairy consumption—animal protein that takes up much feedstock.
3. Biofuels: The use of biofuels is driven by government policy. These mandates are immune to price changes and exaggerate supply shocks from droughts. (The growth of natural gas as a transport fuel has the potential to alter this equation—and hopefully reduce the absurd subsidies to corn ethanol over time.)

On the supply side, it is ultimately about weather, increasing yields and reducing waste.

Weather is actually easy to predict, as long as you focus on long-term trends. Most scientists agree temperatures are rising (the causes are still much debated). This could hurt growing areas such as the US Midwest and South America, while boosting others such as Canada.

How to increase yields? Solutions are agricultural equipment, new technologies to develop drought- and disease-resistant crops, precision farming and no-till practices. All are excellent investment themes.

Food companies also are keen on substituting fatty ingredients for healthier options. These inventions tend to get quicker to market and have lower failure rates than Big Pharma's quest for the next blockbuster drug. Leading players in this field are often part of conglomerates, however, while pure plays tend to be over-owned.

Almost a third of food is wasted globally, a 2011 UN Food and Agriculture Organization study found. In emerging economies, most waste is due to a lack of infrastructure to transport and safely store perishable foods. In the developed world, it is the moldy stuff in the back of the refrigerator and the leftovers of super-sized restaurant meals. Technologies that delay food decay are big opportunities.

Another long-term investment play: a bet on rising rural incomes. After all, you had better odds of making money by selling pick axes or serving whiskey in the California gold rush than trying to dig for precious metal yourself.

A Rebalancing Act: China

China has been a key driver of growth for other emerging markets—the entire world, really. We have seen this movie before. China made up one-third of the world's economy two centuries ago. See the table below.

China is rebalancing toward a consumption society, from a super-charged investment-driven command economy, as detailed in *Braking China ... Without Breaking the World* in April 2012. This is likely to hurt local real estate and heavy industries as well as the global resources sector, we think.

The new course will affect every industry sector. For example, can global luxury good makers deal with China's officialdom's newfound austerity? Shark fin soup and other delicacies were largely absent from dinner tables this Chinese New Year and sales of top-quality watches have plummeted.

It also remains to be seen whether local governments fall in line. China has a long history of provincial autonomy. The saying "The mountains are high and the emperor is far away" has been around for a long time. There is no big Beijing engine room where policymakers only need pull a couple of levers to turn things around.

In this tug of war, inflation, and particularly food inflation, is a worry. There is nothing like the prospect of bread riots turning into mass protests to keep policymakers awake at night.

BACK TO THE FUTURE

Country Shares of Global GDP, 1820–2030

RANKING	1820	1870	1950	1990	2013	2030
1	China 33%	China 17.1%	US 27.3%	US 21.4%	US 23.9%	China 27.9%
2	India 16.1%	India 12%	Russia 7.5%	Japan 8.6%	China 20.1%	US 17.8%
3	Russia 5.4%	UK 9%	UK 6.5%	China 7.8%	India 7.6%	India 11.1%
4	UK 5.2%	US 8.9%	Germany 5%	Russia 7.3%	Japan 6.9%	Japan 4.2%
5	France 5.1%	Russia 7.5%	China 4.6%	Germany 4.7%	Germany 5%	Brazil 3.6%

Sources: University of Groningen and OECD.
Notes: GDP based on purchasing power parity. 2013 and 2030 based on OECD estimates. Flags and country names are of March 2013.

Consumer brands, healthcare and environmental firms, however, may benefit from this long-term trend. The biggest problem: China may be ready for a Chinese slowdown—but the rest of the world probably is not. Investors will likely cry: "hard landing!" (even though China's GDP should still grow at 6% a year or more).

The push to rebalance goes hand in hand with an effort by the country's new leadership to close a widening income gap, crack down on corruption and perhaps even start enforcing environmental protections (they look fine on paper but enforcement tends to be weak).

Even if the leadership's master plan works, big questions remain. Can China's industries, already challenged by rising wages, compete without state-sponsored advantages such as cheap credit and disregard for the environment? What happens if the trickle of capital outflows turns into a flood?

Growing and more visible income inequality causes more sleepless nights. Keeping a lid on local inflation will likely always matter more than boosting global growth.

As in many emerging markets, food makes up a big chunk of China's consumer price index (CPI). China's favorite meat, pork, has an outsized role within the food category (this is why its CPI is also known as the Consumer Pork Index).

The country appears to have given up on once ambitious plans for food self-sufficiency. It has not been able to feed itself for almost a decade now.

Rising incomes and changing diets (more milk and meats, which need much higher grain inputs) are raising the prospect of ever-larger food imports. By contrast, India is still self-sufficient. See the right chart on the next page.

Most of China's arable land is divvied up in small plots. The average farm consists of five people cultivating five *mu* (about a third of a hectare or half an American football field), according to CLSA. Even so, China has improved grain yields and brought them to almost double India's levels, the firm says.

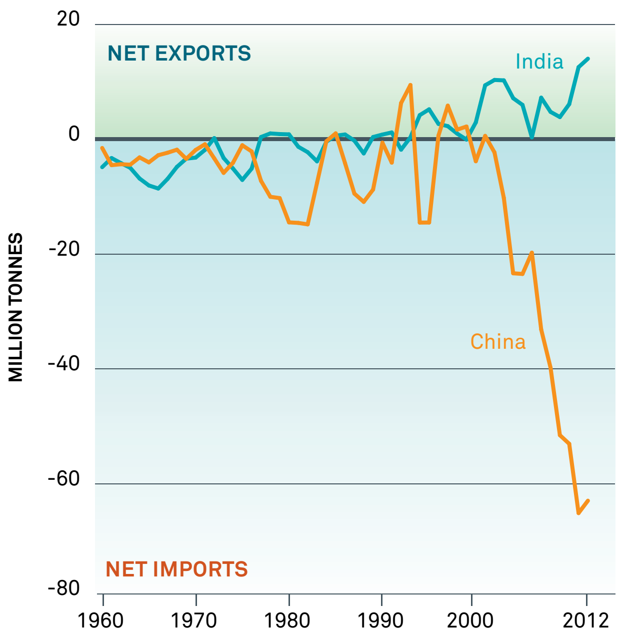
The contrast with India is stark, especially since that country's average farm is four times the size of China's, according to CLSA. There are signs, however, that China is starting to merge smallholdings into bigger farms, the firm says. This underpins demand for farm equipment, techniques and seeds and fertilizers.

China faces big environmental challenges. Water supplies are becoming depleted and polluted. The country's heavy industries and coal electricity generation (coal is king and the king is thirsty) are causing water levels to drop. Competition for clean water heralds local squabbles and potentially international conflicts with neighbors.

Another challenge to farming: Piracy is not limited to movies and luxury goods. As much as 40% of China's fertilizer is fake, CLSA estimates. Fakes can cut crop yields—and profits of bona-fide suppliers. At worst, they poison the food. China's food scandals are a dime a dozen. The Internet has brought increased consumer awareness, and the government appears to encourage "name and shame" campaigns in media and popular blogs.

HOW TO FEED YOURSELF

Net Grain Imports and Exports, 1960–2012



Sources: CLSA and USDA.
Note: Net exports and imports of corn, soy, wheat and rice.

The upshot: Brands are becoming more important.

This bodes well for global food and restaurant players—although even they have setbacks (Yum!'s quarterly sales tumbled when its KFC chicken parts were found laced with antibiotics). Food packaging and food logistics companies also are worth a look, in our view.

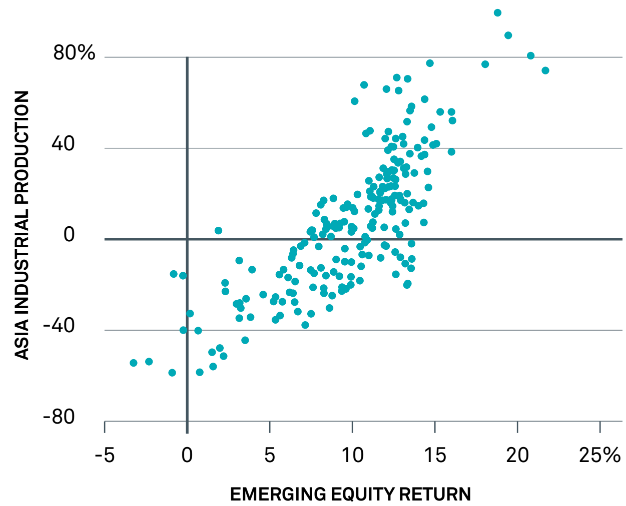
INDUSTRIAL PROWESS

China's industrial might is legendary—and investors parse monthly purchase manager index numbers for signs of strength or weakness.

For broader trends, we prefer to look at Asia-wide industrial production (IP). There appears to be a relationship between emerging stock market returns and IP growth in Asia. The higher the year-over-year Asia IP change, the higher the equity return. See the chart below.

ASIA PRODUCTION KEY

Asia IP and Emerging Equities, 1995–2013



Sources: Thomson Reuters, MSCI and Netherlands Bureau for Economic Policy Analysis.
Note: Year-over-year changes in Asia industrial production and MSCI emerging equities.

We prefer to look at Asia only in this regard because natural resources dominate industrial production in much of the rest of the emerging world.

IP growth in turn is driven by credit conditions and, therefore, susceptible to changes in liquidity. It pays to watch IP data in relation to indices such as BNP's financial and monetary conditions index, as detailed in our 2013 investment outlook *Slow Turn Ahead?* in December 2012.

In the Land of the Blind: Debt

Emerging market debt has arrived. The size of the universe jumped tenfold to about $10 trillion in just 15 years. See the pie charts below. The market capitalization of investable debt increased fivefold to more than $2.5 trillion in the past decade. See the bar chart below.

A global pullback in bank lending has caused emerging market companies to turn to capital markets for funding. In fact, emerging corporate bond issuance exceeded syndicated loans in 2012, according to the Institute of International Finance (IIF).

At what point does foreign ownership become too much? Foreigners own around three-quarters of Australia's government debt, and few investors see that as a problem.

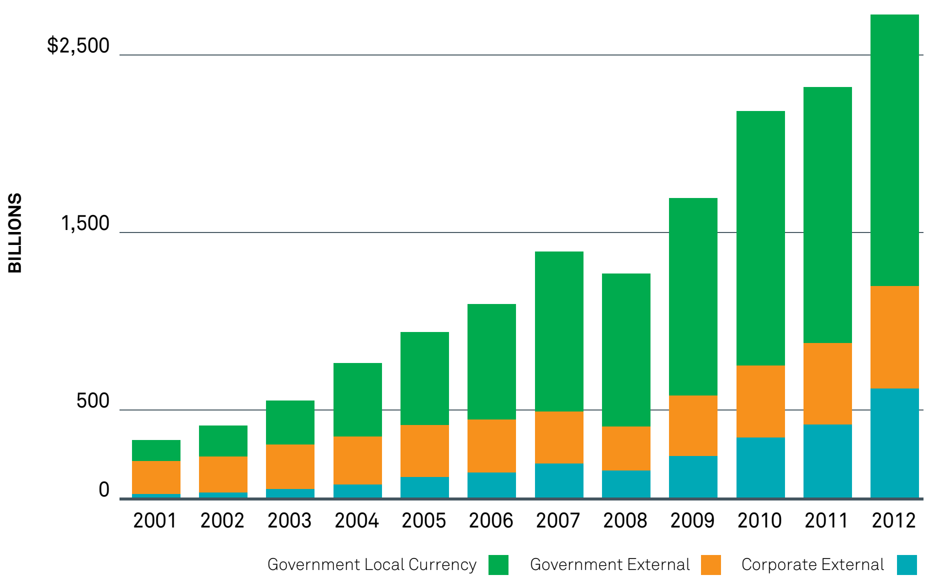
Our rule of thumb for emerging markets: A worsening current account deficit + foreign debt ownership near 50% = potential time bomb. The presence of long-term domestic investors ready to buy when foreigners sell reduces the risk.

The left chart at the bottom of the next page shows the red flag: foreign ownership. This has doubled in many cases since the financial crisis, according to J.P. Morgan. The accompanying right chart shows the mitigating factor: the size of the captive domestic investor base.

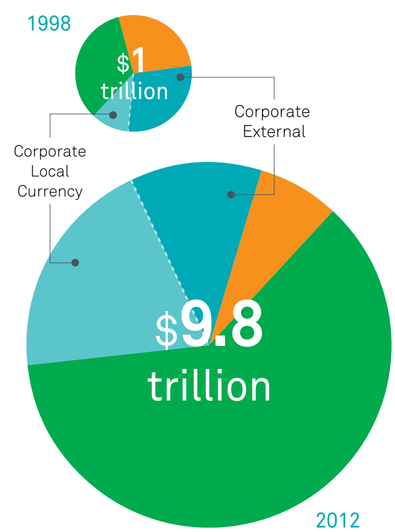
It pays to do your homework. Peru looks hairy on the first measure because foreigners own 58% of its debt, but better on the second with local pension assets making up 17% of the economy.

THE MAKING OF A NEW ASSET CLASS

Investable Emerging Market Debt, 2001–2012



Emerging Debt Universe



Source: J.P. Morgan.
Note: The bar chart represents emerging market debt tied to benchmark indices. The emerging debt universe in 2012 is as of Sept. 30.

Foreigners have been eager buyers of emerging market debt, drawn by its relatively high yield and increased perception of safety. This has brought foreign ownership to record levels in many markets.

Foreigners bring benefits of funding, lower rates and market modernization—but they also are a potential source of volatility. And, as with any rapidly growing young market, some issues appear to have been financed at the wrong price.

This is one reason why the country currently ranks 18th in our 48-country BlackRock Sovereign Risk Index—ahead of the UK and France.

Investors have poured almost $300 billion into emerging market debt since the financial crisis, according to J.P. Morgan. This could be the tip of the iceberg. A 1% re-allocation of global equity and debt portfolios would translate into $485 billion of inflows, the firm says.

Sadly, many investors may have missed the boat. They are itching to enter the market at a time when performance is unlikely to repeat years of double-digit returns because nominal yields are at record lows. Emerging debt still beats negative real rates on many “safe” developed market government bonds, however. See the chart on the right.

Lack of liquidity remains a risk, and we think this is unlikely to improve. Investable emerging market debt is almost three times larger than US high yield, but trading volumes lag. New capital standards and other regulations are making it unattractive for global banks to deal in emerging debt (mitigated somewhat by local banks scooping up discarded business lines). Bottom line: If you buy it, you better love it.

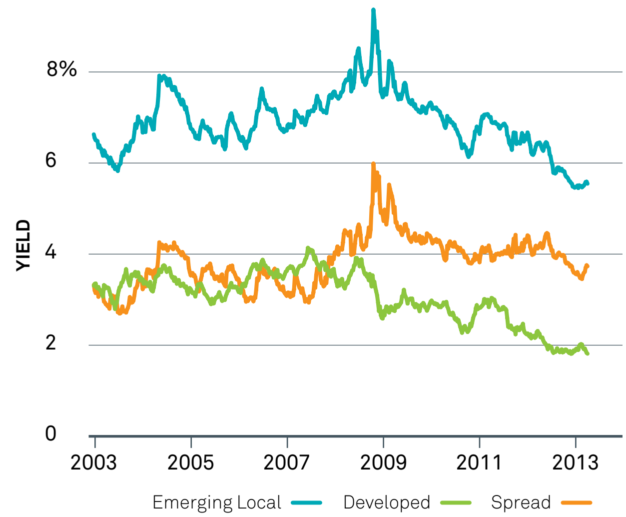
Are we in an emerging market debt bubble? High yield corporate debt issuance currently makes up about half of the corporate total, according to J.P. Morgan. This is a bit worrisome. Absolute interest rates on emerging market bonds are at record lows, and Zambia’s sale of a $750 million bond at a rate lower than Spain’s in September 2012 raised eyebrows.

There are just very few cheap assets in fixed income markets, as detailed in *Forget Rotation: Think Risk Mitigation* in February 2013. A top BlackRock fixed income investor even professes to be “energized by equities.”

The worldwide compression of yields has turned fixed income investing into a relative game. Fixed income investors these days are often faced with a dilemma in the original sense of the word: A choice between undesirable options.

RELATIVE VALUE

Emerging and Developed Market Bond Yields, 2003–2013

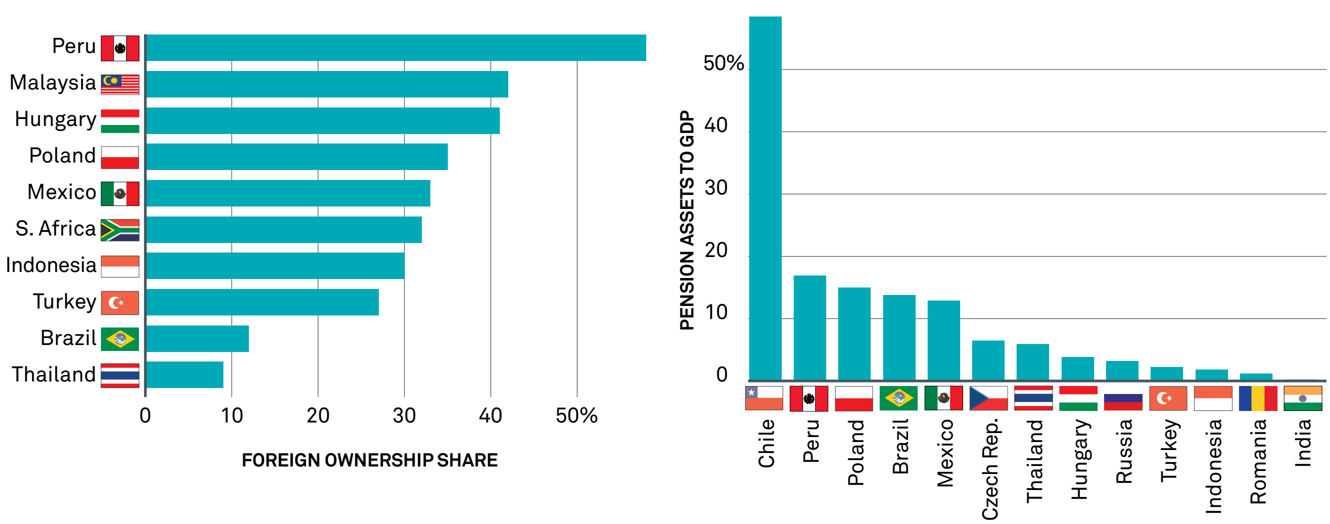


Sources: Thomson Reuters and J.P. Morgan.
Note: Emerging debt is represented by the J.P. Morgan GBI-EM Index and developed debt by the J.P. Morgan Global Bond Index. Data through April 3, 2013.

Emerging market debt looks like a winner in this context. Yields have come down—but not as much as yields of developed world fixed income. Yield spreads have been compressed from the 10%-plus range of the late 1990s. At the same time, however, emerging market debt is trading at higher spreads than before the financial crisis. See the chart at the top of the next page.

FOREIGN AID: A BLESSING OR CURSE?

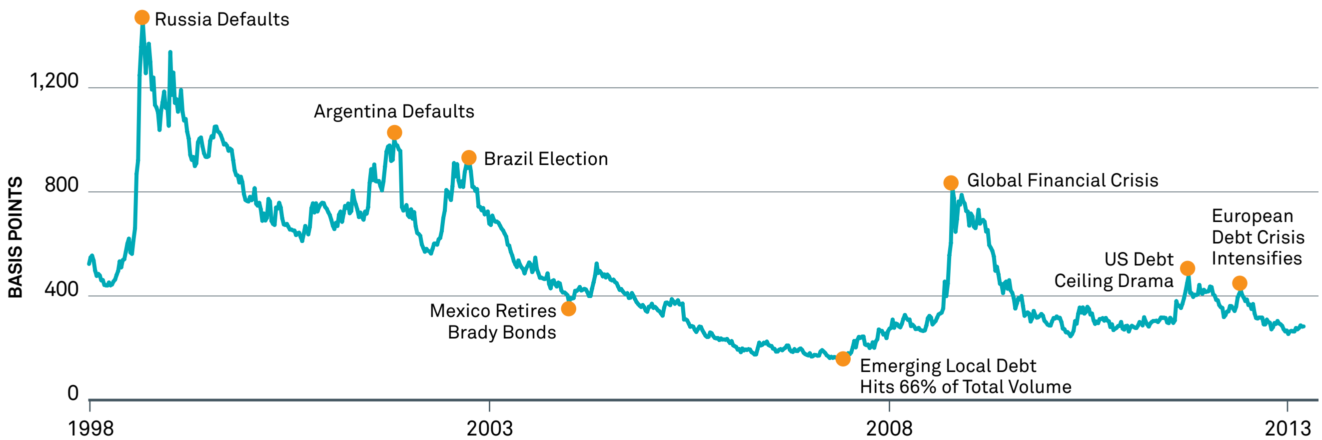
Foreign Ownership of Emerging Market Debt and Local Pension Assets to GDP



Sources: J.P. Morgan and OECD Global Pension Statistics.
Notes: Foreign ownership of emerging market government bonds as of the third quarter of 2012. Emerging market pension assets as a percentage of GDP as of the end of 2011.

HISTORY LESSON

Emerging Sovereign External Debt Spreads, 1998–2013



Sources: Thomson Reuters and J.P. Morgan.

Credit quality has improved greatly. Some 60% of bonds tracked by J.P. Morgan's EMBI index are rated investment grade, up from 40% as recently as 2007. Strong fiscal positions and changed investor perceptions of risk underpin this trend, as detailed in *The Case for Emerging Market Bonds* by BlackRock's iShares team in April 2013.

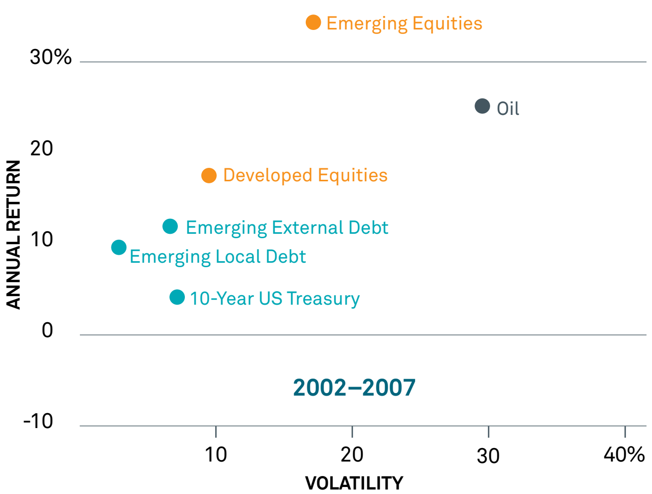
Local emerging debt may offer investors the opportunity to cash in on currency appreciation (or lose on depreciation). Three-fifths of returns on local debt was due to currency movements in the period 2004–2012, as detailed in *Slow Turn Ahead?*

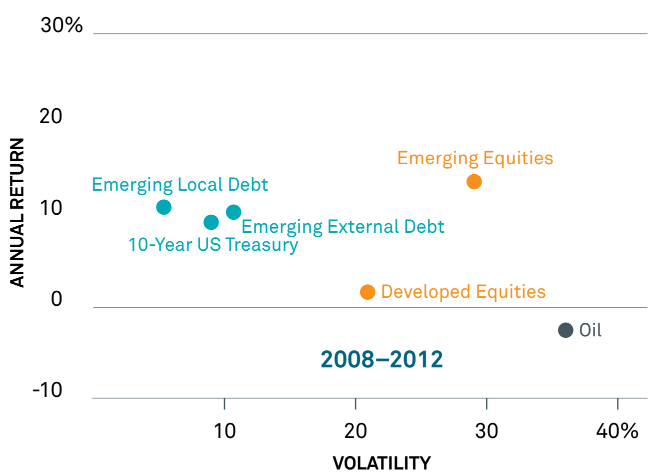
Both local and external emerging bonds weathered the financial crisis and its aftershock better than equities. Annual returns and volatility in emerging fixed income during the past five years were similar to the period preceding the crisis: around 10% a year at annual volatilities of 3%–11%. See the charts below.

Equities, by contrast, delivered lower returns with a lot more risk in the same period. Before the crisis, emerging stocks returned 34% a year at 17% volatility. Since then, annual returns have more than halved (14%) at almost double the risk (29%). See the charts below.

RISKS AND REWARDS

Annual Returns and Volatility of Selected Asset Classes, 2002–2012





Sources: BlackRock and Thomson Reuters.

Notes: Volatility is annualized volatility of monthly returns. Return is the median of rolling monthly annual returns. Emerging local debt is represented by the J.P. Morgan GBI-EM Index; emerging external debt by the J.P. Morgan EMBI Global Index; equities by the MSCI Emerging Equities and MSCI Developed Equities indices; and oil by the S&P GSCI Crude Oil Total Return Index.

When Growth ≠ Return: Stocks

Betting on economic growth alone has mostly been a loser's game in asset allocation.

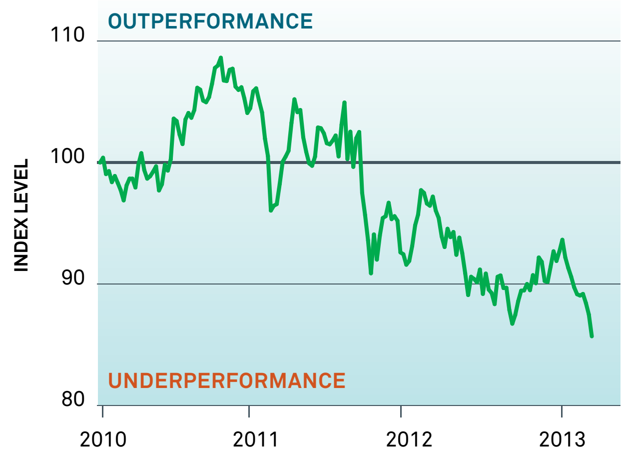
To bring this point home: Emerging market indices underperformed developed world stocks by 15 percentage points in the past three years—even as emerging economies kept up their high growth rates. See the chart on the right.

This could reflect a gradual loss of competiveness amid rising wages and currencies in the emerging world as well as concerns about local credit bubbles. Markets are smarter than we often give them credit for.

Emerging stocks currently look cheap by many valuation metrics (but not on a free cash flow basis—see page 16), both relative to developed countries and their own history. There are huge differences between emerging markets, again underscoring the principle that all emerging markets are not created equal.

PERFORMANCE ISSUES

Emerging Equities Relative Performance, 2010–2013

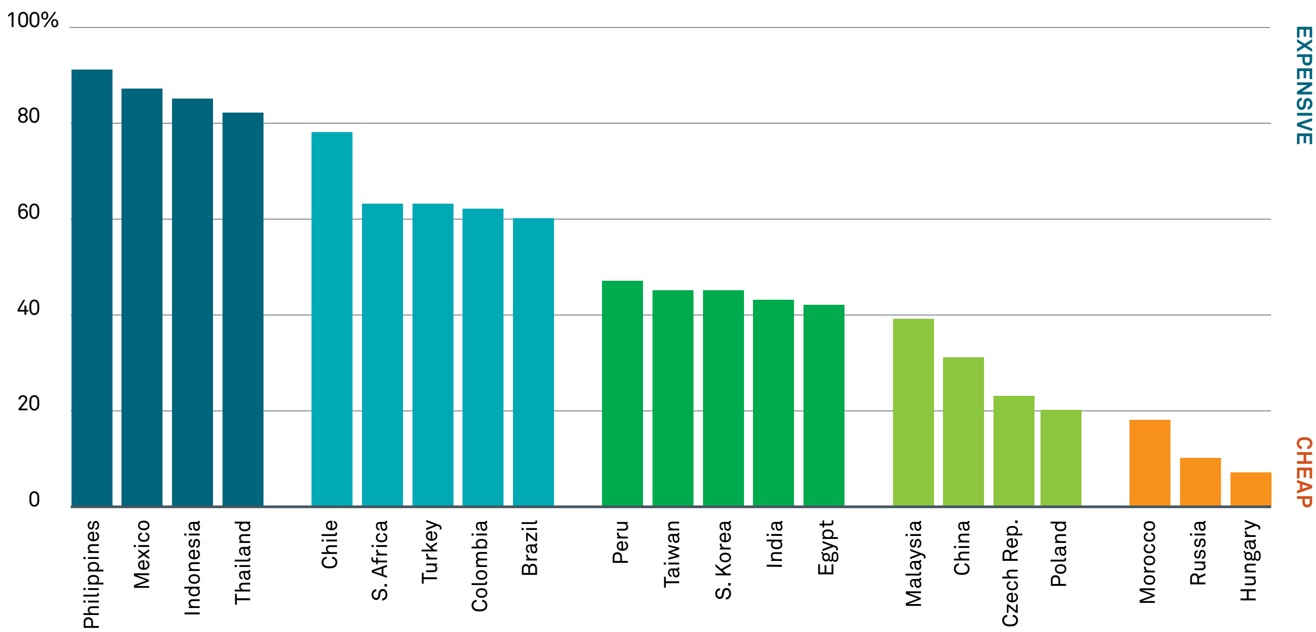


Sources: Thomson Reuters and MSCI.
Note: Index performance of emerging market equities relative to developed stocks. The index is rebased to 100 at the start of 2010. Data through March 14, 2013.

Russia and Hungary, for example, are currently in the bottom quintile of their average valuation in the past 15 years. Southeast Asia, by contrast, is mostly in the top quintile. See the chart below.

VALUE PROPOSITIONS

Emerging Equity Valuations vs. Historic Norms



Sources: BlackRock, MSCI and Thomson Reuters, April 2013.
Note: Current percentile rankings vs. the average of price to forward earnings, price to cashflow, price to book value and dividend yield in the past 15 years.

This does not mean emerging market equities are screaming buys. They look dear on a free cash flow basis. The gap between free cash flow and earnings per share has been widening as companies spend heavily on capital expenditures (capex). Investors on average paid 43 times cash flow for emerging stocks at the end of 2012 versus a more reasonable 15 times earnings. See the chart on the right.

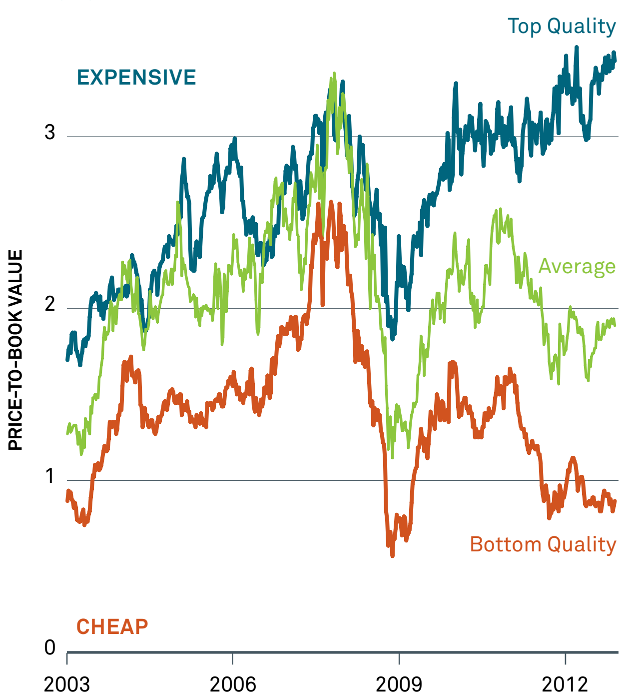
In other words, profits often do not turn into free cash flow in emerging markets. This partly reflects the greater need for capital investment in fast-growing markets (good). It also shows the lack of real return received by non-controlling shareholders (bad).

This is all good if there is a payoff to the capex. Alas, return on invested capital has been flat in markets such as China and India. Investors have started to realize many companies come with a big warning sign: Give us money, and we will torch it.

What to do? Invest in quality companies? The problem: investors have flocked to these stocks. The valuation gap between bottom- and top-rated stocks is the widest in at least a decade. The first group now trades below book value whereas quality companies demand 3.5 times book. See the chart below.

QUALITY PREMIUM

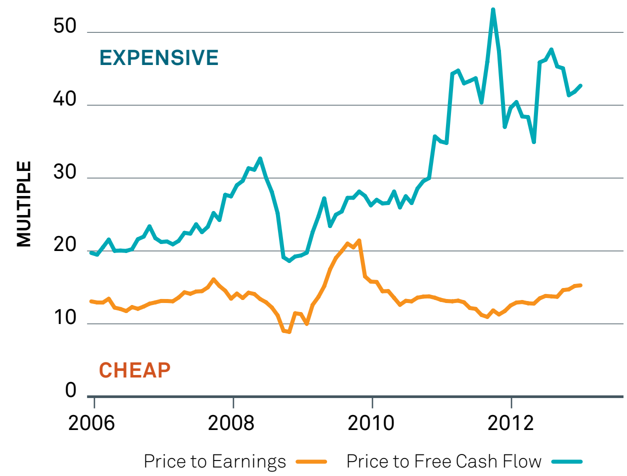
Emerging Equity Book Values, 2003–2012



Source: BlackRock and MSCI.
Notes: The top, average and bottom lines are quality quintiles from BlackRock calculations based on volatility, leverage and dispersion of analysts' earnings estimates. Data through Nov. 30, 2012.

FOLLOW THE MONEY

Emerging Equity Valuations, 2006–2012



Sources: BlackRock and MSCI.
Note: Weighted average valuations.

Newly discovered markets tend to offer more upside—theoretically. The MSCI Frontier Markets Index has a cheaper PE, higher yield and lower volatility than the MSCI Emerging Markets Index. The problem here: These markets are tough to access and exit beyond a few (over owned) names.

Emerging market companies often still have complicated ownership structures (even though corporate governance has improved greatly). Crossholdings and different voting rights make it tough to figure out who owns what. Founding families often like to remain in control—and some are tempted to resort to "tunneling" (digging a tunnel under the house and carting off the valuables).

Investing in emerging income stocks may be a rewarding strategy—and an easy way to monitor good corporate behavior. Consider:

- Emerging income stocks (those yielding 3% or more) outperformed the broad MSCI Emerging Markets Index by a cumulative total of 107% in the decade to March 2013, according to BlackRock research.
- Some 90% of emerging companies paid dividends in 2012 versus just 61% in 2000 (and 87% in the developed world), CLSA estimates.
- Compound annual dividend growth—a key driver of long-term capital appreciation—was almost double (13.7%) the developed world's (6.9%) in the period 2000–2012, according to CLSA.

Growing dividends to all shareholders (funded by growing free cash flows) gets companies a top grade in our classroom.

Red Flag 1: Strong Dollar

An end to loose monetary policies in the developed world looms large—including in the emerging world. Financial markets may look very different in the cruel light of day—much like the blazing lights of New York's Times Square or Tokyo's Ginza fade in the morning.

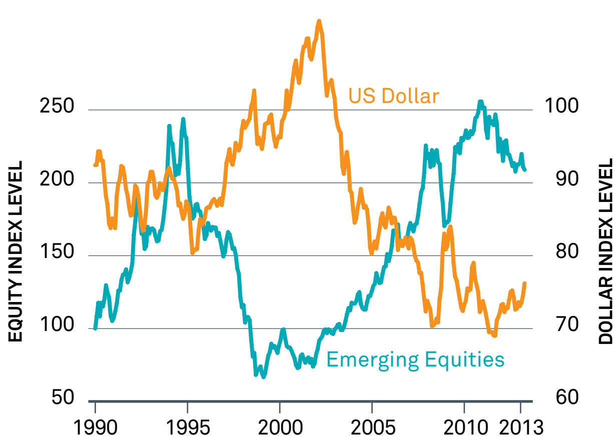
The US Federal Reserve has been the fastest and longest-running contender in a global race to jumpstart growth by quantitative easing (QE). It is likely to take its foot off the pedal first, as described in *Slow Turn Ahead?*

Now combine a Fed shift—and it need only be a subtle one—with other countries working to push down their currencies. (The BoJ's $1 trillion-plus monetary stimulus has pummeled the yen—although emerging market assets may benefit from Japanese inflows).

Then consider the long-term tailwind of US energy production. The US current account deficit is funded by demand for dollars from the rest of the world. Uniquely, the US dollar is widely used outside national borders for transactional purposes—commodities pricing, insurance, shipping and long-term funding. A smaller or larger US current account deficit generates a stronger or weaker US dollar as the supply of dollars declines or rises.

STRONG $ = TROUBLE

Emerging Equities and US Dollar Performance, 1990–2013



Sources: Thomson Reuters and MSCI.
Notes: The equities line represents the performance of emerging vs. developed equities with the index rebased to 100 in 1990. The US dollar line is the performance of the trade-weighted dollar index. Data through March 15, 2013.

The principal source of the deficit is energy. Chinese imports account for much of the remaining deficit. We have no ability to predict the trend of trade with China—it is simply an educated guess. We have a better chance of forecasting energy imports as a result of alternative supply, as detailed in *US Shale Boom: A Case of Temporary Indigestion* of July 2012. The bottom line: US energy imports are set to decline over time, leading to smaller current account deficits and a stronger US dollar.

The result? Global monetary conditions will tighten. Not a great outcome for many emerging markets—especially for those that fund themselves in dollars.

A strong dollar has not been kind to emerging market assets in the past. The dollar's upward march in the late 1990s coincided with a period of underperformance of emerging market stocks (remember the Asia crisis), whereas the inverse happened in the early 2000s. See the chart below. The performance of both local and external emerging bonds shows a similar pattern in recent history.

Does the vast mountain of foreign currency reserves make emerging markets less vulnerable to dollar appreciation than they were at the start of the Asia crisis in 1997? Probably not. Suppose the US dollar rises. The FX accumulator then sells dollars to buy domestic currency. To deliver the targeted price appreciation, it keeps the currency outside the system. In other words, there is a de-facto tightening of domestic liquidity.

Money flows—hot or not—are a constant concern for emerging market central banks and finance ministries. The debate around capital controls and management of global capital flows ignores the importance of flows to the development of financial markets in receiving countries. Not all emerging markets are created equal. The ones with developed domestic debt markets and free-floating currencies are in decent shape to weather US dollar appreciation. Examples are Mexico, Chile and the Philippines.

A strong US dollar could drive up energy costs and food prices as most commodities are denominated in dollars. This could trigger worsening account balances, inflation and social unrest. Think about the underlying causes of the Arab spring.

China's leaders, for example, are acutely aware of the need to keep their people well-fed (and watered). This is why China dominates investments in Africa and Latin America.

Dollar strength does not have to be bad news. If it originates from genuine growth in the US economy, it can be tailwind for emerging market exporters.

Red Flag 2: Credit Growth

Beware whenever credit creation accelerates. It is likely followed by slowing growth at best, and an economic bust and banking crisis at worst.

China's 2009 credit boom is an example—and one reason the recent boomlet (which includes an explosion in US-dollar-denominated corporate bonds, albeit from a low base) worries both investors and policy makers. And those are just the official credit numbers—nobody really knows the size of the shadow banking system.

China's rapid credit growth in the first quarter of 2013 initially gave markets a boost, but later a (valid) reason for concern. The story so far looks to be: The parents (Chinese policymakers) went out to dinner (the leadership change) and the kids (banks and business) started to party—but the parents returned early.

Non-bank funding made up more than half of new credit in the first quarter. Much of this "non-bank" market, however, is actually bank sponsored and, therefore, ultimately a liability of the state. As such, it may have a fiscal and growth cost over time as returns on invested funds could lag investor expectations. It surely will give the panda bears a chance to preach to the China believers.

Wealth management products and trust companies (which have been driving the non-bank credit growth) may turn out to be anything but that. It also means capital inflows will become an even more important part of China's liquidity position—especially because of its declining trade and current account surpluses.

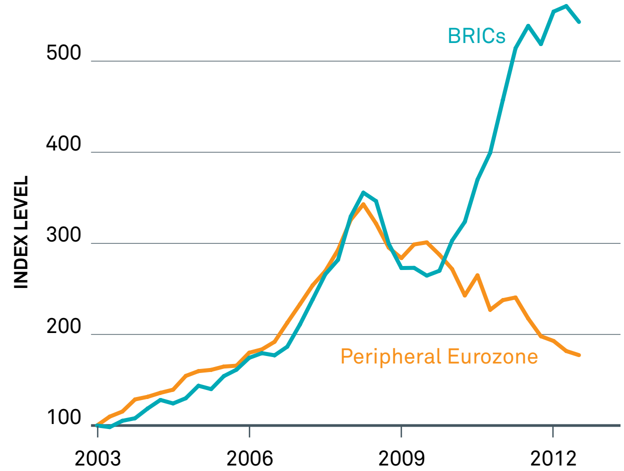
Credit creation by foreign banks is especially dangerous. The lessons of the financial crisis are instructive.

Global banks carpet-bombed the world with money in the run-up. Countries that celebrated with the biggest credit pops, such as Ireland and Spain, now suffer the biggest hangovers. Emerging markets that missed out on the previous boom now look ready to party.

Compare Italy, Spain, Ireland and Portugal with China, India, Brazil and Russia in the chart above. Banks are still pulling out of the troubled eurozone foursome whereas they are supplying the emerging world's Big Four with a flood of credit—at a worrying pace, some would say.

EMERGING CREDIT BUBBLE?

Cross-Border Bank Lending, 2003–2012



Sources: BlackRock and Bank for International Settlements.
Notes: Cross-border claims of reporting banks. Peripheral eurozone defined as Italy, Spain, Ireland and Portugal. Index is rebased to 100 at March 31, 2003. Data through Sept. 28, 2012.

The more reliant countries are on external funding, the more vulnerable they are to dollar strength and the downside of foreign-supplied credit.

The 1997–1998 Asia and 2008 global financial crises showed how excessive reliance on external funding spells trouble down the road.

This is a space worth watching as current account balances of many emerging markets are expected to dip further into negative territory, according to the IIF.

This marks a reversal of surpluses in the past 15 years. Capital inflows are leveling off, with the exception of portfolio investments—the type that can turn on a dime.

EMERGING BUFFERS

Countries that have stable sources of domestic funding—private savings, insurance funds or pension assets—are much better positioned to weather an end to global QE.

The growth in local pension fund and insurance assets is a good buffer. The domestic financial institutions represent a structural onshore demand for assets.

Chile's well-developed pension system has stabilized its capital account. Similar plans appear to develop in Mexico, Peru and Colombia. Elsewhere, governments focus on sovereign wealth or future generation funds.

Bottom line: Emerging markets are starting to harness their savings and welfare needs.

Likes, Dislikes and Debates

Likes	WHY	TIMEFRAME
Mexico Debt (But Not Equities)	Mexico's manufacturing competitiveness is resurging vs. Asia's. There is potential for structural reform (including freeing up the key energy sector). The currency is cheap (though widely owned). The country is also a leveraged play on a US housing revival. Monopolistic enterprises dominate the (expensive) stock market—and are at risk of being broken up.	12–18 months
Russia-India Equities Combo	Russia is cheap, unloved and underowned, and has prospects for structural (but not political) reform. A new sovereign wealth fund provides the government with an incentive to give markets and investors a helping hand. Consider adding equities from fiscally challenged India to hedge Russia's vulnerability to falling oil prices. India would benefit from a lower oil import bill. Plus, it is implementing business-friendly measures for foreign investment, a nationwide value-added tax and direct subsidies to the poor through its unique identification program.	12 months
Brazil Equities	Investor sentiment on Brazil soured after a loss of economic momentum, poor equity market returns, worrying credit growth and a series of government interventions in key industries such as banking and energy. It will not take much for the tide to turn in this relatively cheap market. Recent reforms such as a diesel price hike are encouraging. Nothing like a slowing economy to force policymakers to enact reform.	12–18 months
Frontier Markets	Cheap stock valuations, high bond yields and low volatility. What is not to like? A lack of investable assets.	Until tourist investors show up
Agricultural Technology, Services and Equipment	Increasing populations, urbanization, growing incomes and changing diets in the emerging world represent structural demand for food. This should benefit agricultural equipment and logistics as well as seed and crop science, Water resources are being depleted, putting a premium on water technologies. We like land but think it is too much work to extract real value (we are mostly city folk). We dislike buying and holding the actual commodities (high prices give farmers an incentive to produce more, ultimately pushing down prices) and corn ethanol (reliant on misguided government mandates).	Until 2050—when world population is supposed to top out

Dislikes	WHY	TIMEFRAME
Turkey	Heady credit growth, lofty valuations and a dependence on external funding. The country has been bumping around in the fourth quintile of the BlackRock Sovereign Risk Index.	1–3 years
China Equities and High Yield	We are spooked by a spurt in credit growth, underreported bad loans and a shadowy shadow banking system. China's money supply growth partly depends on dollar funding channeled through Hong Kong, making it vulnerable to a strong US dollar. Rising wages are hitting corporate profits, and food inflation could cause monetary tightening measures. Then there are concerns of corporate fraud, an aging population and a degraded environment.	2 years

Debates	WHY	TIMEFRAME
India Equities and Debt	India offers a tricky combination of a growing working population, slowing economy and a democratic government that is broke. The country also remains vulnerable to a spike in energy prices and has a poor infrastructure. On the plus side, recent reforms may be the real thing (see above), equity valuations are reasonable (by their own history) and India's young, entrepreneurial and mostly rural population sets the stage for long-term growth. The 2014 presidential election could boost market sentiment later this year, depending partly on who leads the BJP party (and the response of the rival Congress party).	We may never agree
Southeast Asia	Bubbly conditions with high equity valuations (check out Indonesian banks), tight spreads, a rise in credit, lots of portfolio inflows and a reliance on dollar funding (Indonesia again). Political risk is always lurking. On the plus side, the region is a prime beneficiary of businesses fleeing China's wage inflation, bouts of anti-Japanese sentiment and deteriorating environment. And local incomes and consumption are rising rapidly.	Until we make up our mind
External Emerging Debt	External emerging debt looks pricey—and yet more (corporate) supply is coming down the pipeline. Compressed spreads mean duration risk is high and the potential for price appreciation mathematically challenged. There is liquidity risk with some small issuers running classic roach motels: You can check in but you cannot check out. On the plus side, external emerging debt is a great defensive asset. It would likely better stomach an end to US QE (and stronger dollar) than local debt. It still offers a measurable pick-up in yield compared with "safe" developed market bonds in a world starved for income. And sovereign external debt is in short supply.	The end of easy money will tell

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