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iShares Market Perspectives

Are Emerging Markets the New Defensives?

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Executive Summary

For much of the past 30 years, financial shocks mostly originated in emerging markets. However, the epicenter for the worst economic crisis in generations was clearly in the developed world. And as the global economy struggles to stabilize, Europe, Japan, and arguably the United States continue to be major sources of systemic risk.

Emerging markets are not without their share of macroeconomic problems – inflation, corporate governance, and potential credit bubbles to name but a few. But many of these countries have made tremendous strides over the past decade and for the most part, appear more stable and suffer from fewer imbalances than ten years ago. In fact, not only do most emerging markets compare favorably with their own histories, today they also do so with more established, developed markets.

The improvement in macro stability is beginning to be mirrored in a shift in volatility. While emerging markets suffered in September, over the past several years the difference between emerging market and developed market volatility has shrunk. This decline in relative volatility appears justified in light of improving macroeconomic stability and better growth prospects, and we would expect it to continue.

In light of these changes, we believe that investors should adopt a more nuanced view of emerging markets. Rather than treating them as just a high-beta, levered play on risky assets, investors should focus on the ability of certain emerging markets to provide a defensive play in the event of a recession in the developed world — with the caveat that the impact of another global recession would be ubiquitous, as it was in 2008.

So those who are last now will be first then, and those who are first will be last.
Matthew 20:16

Reversal of Fortune

Two of the few, but painful, hiccups in the long bull market of the 1990s were the Asian contagion and the Russian default. The events of 1997 and 1998 provided a short-lived, but frightening interruption in a remarkably smooth secular bull market. At the time, the events seemed as dangerous as the real meltdown that would occur a decade later. But while many aspects — frozen markets, no liquidity, failed institutions — of the 1998 sell-off would be all too familiar to today's investors, the proximate cause was quite different. At the time, the euro had yet to come into existence and the United States was enjoying one of the longest stretches of economic growth in its history. The "problem children" were emerging markets, including markets as diverse as Russia and Thailand.

A decade or so later, the situation looks quite different. Consider the change in fortune of Thailand, one of the catalysts for the emerging market contagion of the late 1990s. In 1998, Thailand had foreign debt equivalent to more than 90% of gross domestic product (GDP). By contrast, in 2012 Thailand's foreign debt exposure is forecasted to be barely 20% of GDP.

This is just a single metric, but the secular improvement in emerging market macro conditions cuts across various dimensions: economic growth, current accounts, fiscal budgets, and even inflation. While most emerging markets sat out the rally in early 2011 due to accelerating inflation, the problem was still an order of magnitude less than it was 15 years ago. Investors are rightly concerned over inflation of 7% in Brazil and 9% in Russia, but in 1995, inflation rates for those two countries were 25% and 225%, respectively!

The long-term decline in inflation is not limited to Brazil and Russia, but is indicative of a broader trend. For 2011, inflation in emerging markets is expected to be 7.5%, a meaningful acceleration from 2009 when it was running at barely 5.0%. However, taken in a longer-term context this is still a significant improvement. As recently as 2008, emerging market inflation was more than 9%, and between 1995 and 1999 it ranged from a high of 39% to a low of 13%.

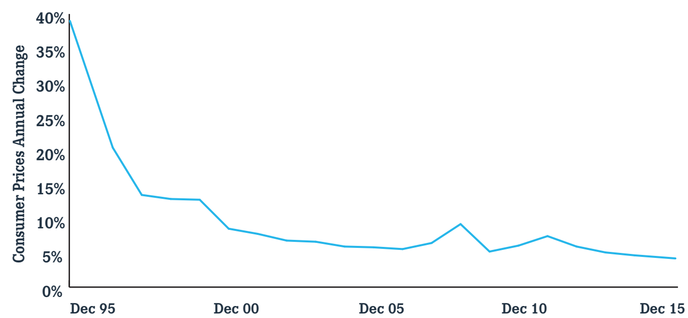
Less Macro Volatility, Less Financial Volatility

Not only has inflation dropped, it has become less volatile. Over the past three years, the monthly volatility in Brazilian inflation has been 0.25%, less than half of its 2005 level. This drop in the volatility of inflation is important for financial assets, including stocks. Historically, market valuations are higher when inflation is lower, but they also fare better when the *volatility* of inflation is lower (investors respond to less uncertainty in the macroeconomic environment).

Moreover, this moderating trend is important because there is a direct link between economic volatility and financial volatility for most economies. As the volatility in the underlying economy drops, so does the volatility of financial assets, particularly stocks. This is arguably the main reason why financial markets have been so volatile these past four years: there has been a rise in the underlying volatility of the global economy.

CHART 1

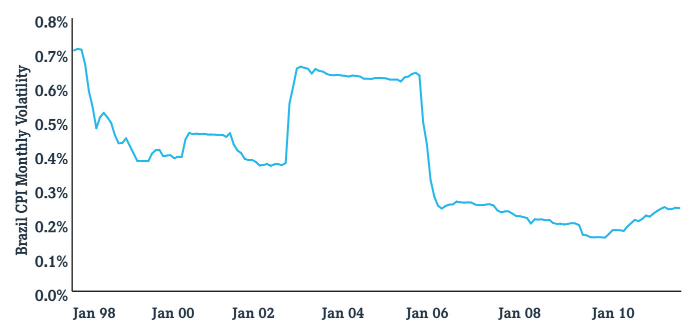
**IMF Emerging Market Inflation
1995 to Present**



Source: Bloomberg, 8/31/11.

CHART 2

**Volatility of Brazilian Inflation
1998 to Present**



Source: Bloomberg 7/31/11

However, while virtually all measures of global economic activity have become more volatile, as highlighted in chart 3, macroeconomic volatility in emerging markets has risen less dramatically.

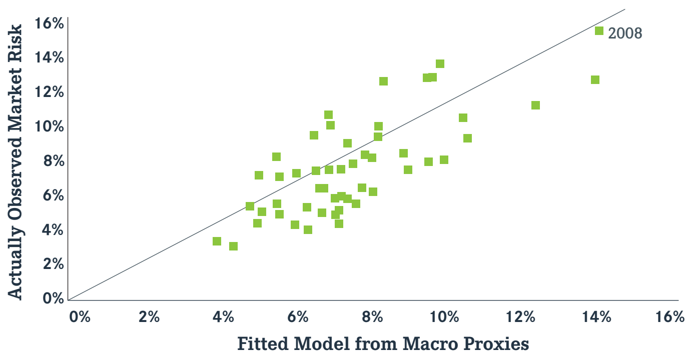
In developed markets, most macroeconomic indicators are much less stable than they used to be. Although inflation generally remains low in most developed countries, the volatility of inflation has risen dramatically in recent years. In the United States, the trailing five-year volatility of the Consumer Price Index (CPI) is now close to its highest level since the 1950s. Overall economic growth reveals a similar pattern with the volatility of US GDP now twice what it was in 2005.

Not surprisingly, given the discrepancy between the relative stability in the macro environment in emerging markets and increasingly volatile economies in the developed world, volatility of emerging market financial assets is declining relative to developed markets. True, emerging market volatility is higher than it was back at its trough in 2007, but its rise has been less dramatic than during previous downturns. Four years ago, volatility bottomed out at less than 5%; today it is close to 9%, a fairly modest increase.

In contrast, as of this writing, volatility in developed markets has tripled from its 2007 levels and remains close to its recent peak. As a result,

CHART 3

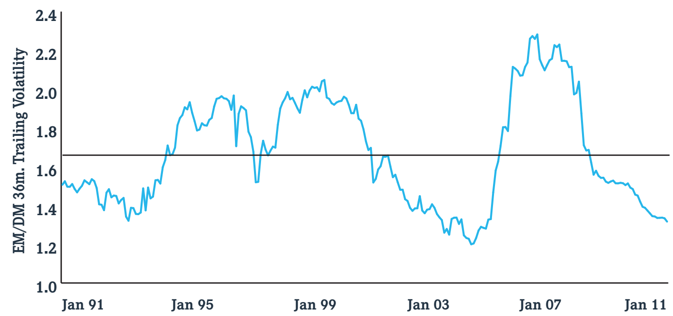
Market Risk and Macroeconomic Risk



Source: Bloomberg 6/30/2011

CHART 4

Relative Volatility of Emerging Markets vs. Developed Markets



Source: Bloomberg 8/31/2011

the relative spread between emerging market and developed market volatility is close to a historic low.

Another way to measure the changing risk profile of emerging market stocks is to analyze the relationship between emerging market equity returns and investors' preference for risk, i.e., risk appetite. For most of the past 20 years, emerging markets were the quintessential risk play, meaning that this was the vehicle of choice when investors wanted to take on more risk. To some extent this is still true, as these markets generally have a higher beta[1] relative to global equity returns than developed markets. However, the sensitivity of these markets to changes in investor sentiment is not as high as it's historically been.

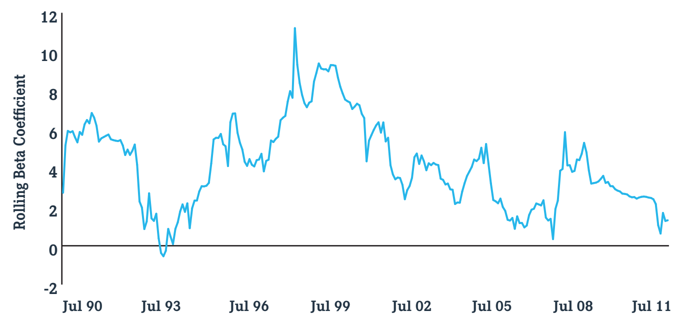
To quantify investor sensitivity, we compared the performance of the MSCI Emerging Markets Index to a proprietary measure of risk appetite. The risk appetite index is derived by measuring market momentum, credit conditions, and leading economic indicators to gauge investor preference for risky assets. The higher the beta coefficient, the more investors are in a risk-seeking mood; conversely, negative numbers are associated with risk aversion.

As shown in Chart 5, emerging markets had a beta of around 10 to the indicator at the 1998 peak, meaning that you would expect emerging market stocks to rise by 10% in a month when the indicator was at 1. If the indicator was at –1, emerging market stocks would be expected to fall by around 10%. For most of the last decade, the beta of emerging market stocks to risk appetite has been steadily decreasing.

Today, emerging market securities display significantly less sensitivity to risk appetite. The beta of emerging market equities to risk appetite is around 1.3. While this is still nominally higher than developed markets, the statistical difference is insignificant and suggests that emerging markets are no more sensitive to this particular measure of risk appetite than are developed markets. Though we would still expect emerging markets to react more violently to issues idiosyncratic to these countries — i.e., a Chinese banking crisis — the changing structure of these economies means that they may no longer be the "go-to" asset class for putting on or taking off risk.

CHART 5

Emerging Markets Beta to Risk Appetite
1990 to Present



Source: Bloomberg 8/31/2011

Why Emerging Markets May Offer Some Protection

In 2008, investors were treated to a brutal display of why diversification does not always work in the short term. In the midst of a global recession and liquidity crisis, the world bifurcated into two asset classes: safe havens — which at the time included US Treasuries and gold — and everything else. Having geographic or asset class diversification proved of little use. If today's dire forecasts prove correct and we're slipping back toward a replay of the global financial crisis, then we would assume that this dynamic would repeat and emerging markets would offer little downside protection.

However, if the global economy manages to sidestep another severe recession and instead continues to creep along with anemic but positive growth, we believe that a number of emerging market countries can offer both enhanced growth prospects and arguably less risk. In particular, we'd focus on three broad advantages of emerging markets: better growth prospects, less dependency on foreign borrowing, and healthier fiscal positions.

[1] A measure of the tendency of a security's price to move with the market at large. The higher the beta, the more volatile and riskier a security is.

First and foremost, emerging markets are likely to grow faster than developed markets over the next five years, at minimum. And, it's worth highlighting just how strong the relative discrepancy is likely to be. The International Monetary Fund (IMF) is expecting emerging markets to achieve real growth of approximately 5% between now and 2016. At the same time, the estimate for developed markets is barely 2%, which given the ongoing deleveraging might prove optimistic. A combination of better demographics, improving productivity, and a lack of crippling debt should produce superior growth in emerging markets for much of the next decade.

It is true that there is little to no long-term correlation between economic growth and market returns, but there is significant correlation between economic growth and both profit growth and earnings multiples. Companies levered to emerging markets — both local and those in developed countries — may enjoy the tailwind of faster economies which typically translates into better top-line growth. In addition, multiples tend to be higher in environments in which economic growth is higher. All else being equal, better growth should lead to higher relative valuations.

A second source of stability for emerging markets is that most of these countries have managed to mitigate or in some cases (such as Russia) virtually eliminate their dependency on foreign capital. This was a major source of instability in the late 1990s and it seems that most emerging markets have learned their lesson.

In the late 1990s, emerging markets had foreign debt equivalent to nearly 40% of aggregate GDP. Immediately following the 1998 financial crisis, these ratios began to fall as most of the large emerging markets adopted a series of measures designed to lower their dependency on foreign capital. By the time of the 2008 financial crisis most emerging markets were in a much stronger position, with foreign debt-to-GDP ratios of 25%. That number is expected to fall even further, with the IMF estimating that foreign debt-to-GDP will be 20% next year.

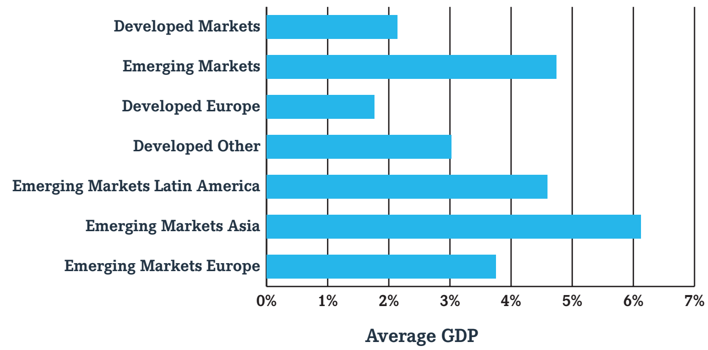
In addition, most emerging markets have addressed a related source of instability, current account deficits. Most of the large emerging markets in Asia — China, Taiwan, Thailand, and Malaysia — are running current account surpluses, as is Russia. Even in those countries with current account deficits, such as Brazil, they are relatively modest, at less than 3% of GDP (one exception is Turkey, which is currently running a particularly large current account deficit).

Finally, and perhaps most importantly in light of the sovereign debt problems in the United States, Europe, and Japan, most emerging markets have embraced a level of fiscal discipline that still eludes most large, developed countries.

According to the April 2011 edition of the *IMF Fiscal Monitor*, advanced economies will be running deficits equal to approximately 5.2% of GDP n 2012. In contrast, deficits in emerging markets should be just 2.2% of GDP. Nor is this simply a short-term phenomenon. Worsening demographics and strained entitlement programs are projected to cause a continued deterioration in the fiscal health of developed countries. The same report suggests that by 2015, gross debt-to-GDP ratios should be roughly 110% in advanced economies versus around 30% for emerging market economies. In comparison to the developed world, most developing economies appear to be paragons of thrift.

CHART 6

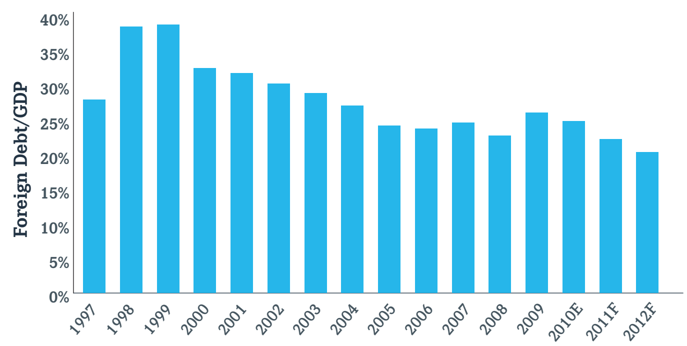
IMF Expected Real GDP Forecast 2011 to 2016



Source: Bloomberg, IMF 8/31/2011

CHART 7

Foreign Debt as a % GDP 1997 to 2012



Source: Bloomberg 7/31/2011

Behavior has Already Started to Change

As previously discussed, emerging markets were not shielded from September's sell-off, which will prompt some to question whether investor perception has really changed. While it is true that emerging markets got hit worse than developed markets in September — despite the fact that Europe was the proximate cause of the selling — investors are already adjusting their behavior towards these markets. One example of this is how investors react to changes in perceptions of solvency.

The relative deterioration of the fiscal health of developed countries impacts financial assets in a variety of ways. The meltdown in southern Europe has provided a cautionary tale on the dangers of unsustainable budgets. This newfound caution can be seen by tracking the recent change in credit default swap (CDS) spreads. Historically, investors demanded a higher premium for insuring emerging market debt. This higher premium was reflected in the form of higher CDS spreads for emerging market countries.

More recently that trend has started to reverse, particularly in Europe. In January of 2008 the average CDS spread for large European countries was 9 bps. For the PIIGS (Portugal, Ireland, Italy, Greece, and Spain) it was 36 bps. As of July 31 the numbers were 82 and 821, respectively. In contrast, in emerging Europe and Africa spreads have been more stable, moving from 103 bps in 2008 to 168 bps at the end of July. In Asia and Latin America, CDS spreads for emerging markets have actually *declined* over the past three and a half years, from 123 bps down to 109 bps. In other words, perceptions of where risk lies have changed dramatically since the start of the financial crisis.

This change in the relative risk surrounding sovereign debt is important for equity investors as well. The value of a stock, sector, or country is a function of many factors, including solvency. Markets generally command a higher valuation when the perceived risk of a default is low and spreads are small, with multiples contracting as risk rises and spreads widen. We can measure this relationship by comparing the average price-to-book ratio of an index (such as the German DAX) against the CDS spreads for that country. This provides a metric of investor sensitivity to the perceived change in sovereign risk for that country. In other words, how much of a haircut do investors apply to a country when it's perceived as less solvent?

In the past — given their greater risk — emerging markets were much more sensitive to CDS spreads, evidenced by a higher regression coefficient than developed markets. However, over the past three years that historical pattern has begun to shift. With investors now focused on the near-term risks of a default in developed Europe, and the longer-term solvency issues surrounding the United States and Japan, developed markets have become more sensitive to default risk — as measured by CDS spreads — than emerging markets. Investors are now more sensitive to solvency questions in the Old World than the New.

Perceptions around emerging markets are changing in the political arena as well. A recent story in *The New York Times* on the potential return of Vladimir Putin as president of Russia epitomizes the new assessment, noting "A consensus is emerging among bankers, economists and companies that evaluate market risk that the return of Vladimir V. Putin as Russia's president will be a net positive for foreign investors — regardless of whether they support the politics of it."[2] Similar statements could be made about other emerging markets.

This change in investor behavior has two implications. First, assuming these changes continue, emerging markets are likely to be less sensitive than many developed ones to changing perceptions of solvency risk. Second, if emerging markets are safer across this dimension, this should eventually be reflected in valuations, with emerging market equity multiples rising relative to developed markets.

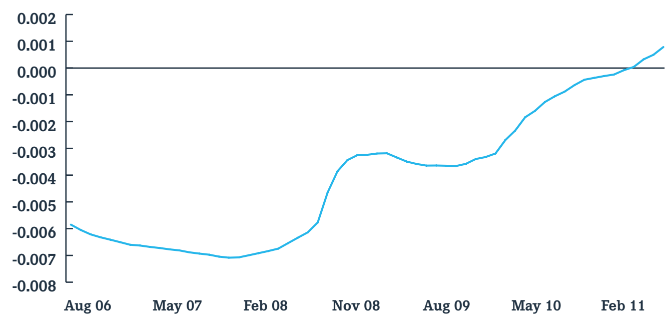
Conclusion

Let's face it, Tom, and all due respect, the Don, rest in peace, was slippin.' Ten years ago, could I have gotten to him?
Virgil "The Turk" Sollozzo to Tom Hagen — *The Godfather*

Over time, investors develop perceptions on the relative riskiness of an asset or asset class. Ten years ago it was well understood — and true at the time –that technology stocks were more volatile and riskier than any other sector. Since then, the beta on technology stocks has decreased from 2 to around 1.1. Today, technology stocks are not much more volatile than the broad market. At the same time, industrials,

CHART 8

Difference in CDS Coefficient btw DM and EM Countries 2006 to Present



Source: Bloomberg 8/31/2011

materials, consumer discretionary, and financial stocks have all become riskier than in the 1990s. This does not mean that technology is a buy, but simply that these stocks react less violently to changes in investor sentiment than was the case a decade ago.

A similar shift in relative risk is occurring at the country level. The volatility of the financial assets of a country or a region is typically driven by the underlying macro risk of that economy, captured in statistics such as inflation, economic growth, and solvency. Over the past decade, emerging markets have witnessed a steady improvement in most measures of macro risk. At the same time, a secular deterioration in state finances, coupled with the financial crisis, has accelerated a longer-term slide in developed markets. Our view is that these trends are likely to remain in place for the foreseeable future. As a result, we continue to believe that on a relative basis, emerging market risk will converge with that of developed markets.

Our view is not that investors should permanently overweight emerging markets, as there will be periods when these countries face their own idiosyncratic headwinds, such as was the case for most of this year. However, we are suggesting two changes. First, investors who manage portfolios based on risk-adjusted returns should revisit their assumptions on the relative risk of emerging market versus developed market economies. Second, from a tactical perspective, we believe that investors should not let the current bout of risk aversion push them out of their emerging market positions. We believe that there are a number of emerging markets that could act as relatively defensive plays as developed countries struggle to stabilize their economies. Currently, some of our favorite picks are Latin America — particularly Brazil — Turkey, and Russia. At first glance, these might seem like strange places to go to insulate a portfolio against turbulent times. Obviously, investment in these countries comes with significant risk. Of course, these days the same could be said of Spain, Italy — and even the United States.

[2] Kramer, Andrew E., "For Investors, Russia's Putin is Good for Business," *The New York Times*, September 27, 2011.

TABLE 1

CDS Spreads by Country

	Date	7/30/11	1/29/10	1/31/08	% Change 7/11 from 1/10
EMEA	Turkey	192.73	193.11	206.61	0%
	Egypt		248.72	148.50	
	Hungary	311.28	246.35	79.17	26%
	Israel	141.64	123.22	50.67	15%
	Poland	166.22	135.33	47.50	23%
	Russia	141.87	191.68	109.96	–26%
	South Africa	125.45	160.31	157.57	–22%
	Czech Republic	96.80	95.83	31.75	1%
	Average	168.00	174.32	103.97	–4%
PAEM & LatAm	Brazil	113.55	144.02	135.69	–21%
	Chile	71.21	76.69	65.00	–7%
	China	86.63	82.66	55.90	5%
	Colombia	111.77	168.17	181.66	–34%
	Indonesia	133.08	190.34	211.83	–30%
	Malaysia	92.33	103.89	72.33	–11%
	Mexico	111.00	150.34	110.00	–26%
	Peru	122.87	145.42	145.30	–16%
	Philippines	132.34	181.29	209.79	–27%
	Korea	103.00	105.61	76.10	–2%
	Thailand	122.65	113.49	89.64	8%
	Average	109.13	132.90	123.02	–18%
PIIGS	Greece	1721.77	398.07	44.83	333%
	Ireland	789.84	149.19		429%
	Italy	310.24	119.83	32.83	159%
	Portugal	924.06	159.55	37.35	479%
	Spain	362.99	124.00	29.50	193%
	Average	821.78	190.13	36.13	332%
Europe	Austria	91.96	86.06	8.10	7%
	Belgium	199.26	63.22	17.50	215%
	United Kingdom	73.75	83.93		–12%
	Denmark	87.78	33.23		164%
	Finland	49.84	32.70		52%
	France	122.05	49.45	9.75	147%
	Germany	64.25	34.25	7.25	88%
	Netherlands	56.67	34.63		64%
	Norway	31.83	18.86		69%
	Sweden	42.58	49.71	5.44	–14%
	Average	82.00	48.61	9.61	69%
USA etc.	Hong Kong	61.45	48.28		27%
	Japan	90.64	84.61	15.42	7%
	New Zealand	69.36	58.70		18%
	Australia	57.00	47.65		20%
	USA	62.19	43.80		42%
	Average	68.13	56.61	15.42	20%

Source: Bloomberg 7/31/2011

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Are Emerging Markets the New Defensives?
Some Examples of Investing with Potential iShares Solutions

	Potential iShares Solution
Broad Emerging Markets	iShares MSCI Emerging Markets Index Fund (EEM) iShares S&P Latin America 40 Index Fund (ILF)
Specific Emerging Markets	iShares MSCI Brazil Index Fund (EWZ) iShares MSCI Turkey Investable Market Index Fund (TUR) iShares MSCI Russia Capped Index Fund (ERUS)

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