Emerging markets bubble is worth riding
James Saft

Emerging markets are very likely the next bubble, but don't let that stop you.

Emerging market shares are already expensive relative to developed market ones, but economic growth in places like China and India will continue to pull away, and investors will pay an increasing premium for that, especially if the aging economic giants of the 20th century slip from their long-term economic growth paths.

And in a process we've seen before with Internet stocks and houses, big returns will attract big money, driving further rises and making it all seem very sensible, at least for a while.

The definition of "a while" is of course, as with all bubbles, the key question.

Amazingly, the case for emerging markets being both a bubble and a good investment is being made by a legendary value investor, Jeremy Grantham.

"This bubble, like all bubbles, will not be justified by long-term value but at least will be one of the least flaky bubble cases ever," Grantham, chairman of the fund manager GMO, wrote in a note to clients.

He points out that U.S. gross domestic product has in recent years been growing at below its long-term 3.5 percent rate in real terms, despite a very supportive global environment and huge amounts of cheap financing.

At the same time, economic growth in emerging markets is higher, and is supported by boom prices for commodities and by a seemingly unstoppable movement of people into cities, driving both consumption and higher productivity.

Grantham's thesis, essentially, is that these diverging trends will continue, that everyone will realize it and that they will pile into emerging markets, thus inflating the bubble.

How big a bubble? The Japanese bubble peaked at price-to-earnings ratios two to three times those of the rest of the world's stocks, while the Nasdaq bubble reached similar figures, according to GMO. Grantham argues that emerging markets could achieve a premium of 50 percent, which would be "far less than normal," but still a heck of a lot higher than current levels.

Emerging market shares are now more expensive on a reported earnings basis than developed market stocks, a historically unusual situation.

So, investors are paying more for a dollar in emerging markets earnings than they will for a developed earnings dollar, and a major relative change in valuation has already happened.

Can this continue, even if economic growth in the United States and Europe is weak?

Andrew Lapthorne, global quantitative strategist at Société Générale Corporate & Investment Banking in London, is not so sure.

"Are emerging markets a commodity play? Yes," he said. "Do they have better growth prospects? Yes. Can they withstand a slowdown in the United States and Europe? Probably not."

Grantham, for his part, said he believed the bubble would be influenced, and perhaps delayed, by problems elsewhere.

"Such interruptions may be quite violent but, despite them, at the next low point for the U.S. market the emerging markets are quite likely to do no worse and in the recovery they will go to a very large premium," he writes.

There are other arguments in support of emerging markets that are actually strengthened by the woes elsewhere.

Debt is lower in emerging markets than developed, both at the corporate and household level. If we are going through a sustained period of lowering the amount of borrowing that is acceptable, Asian banks and consumers are less exposed.

And the increasing affluence of consumers in emerging markets offers another potential stabilizer. Credit Suisse points out that about half of global emerging market exports are to other emerging markets, as against 18 percent to the United States.

There is also a school of thought that says, like it or not, global financial capitalism is inherently prone to bubbles, so we should all just relax and enjoy it.

Since the U.S. Federal Reserve Board and the other central bank authorities have demonstrated that they will step in to cushion the effects of a popping bubble but not act to stop one from inflating, you can be forgiven if you think it might be fun to hitch a ride.

It may be moral hazard, but what, after all, is a speculator to do? Just make sure you get out good and early.

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