MarketWatch

Emerging Markets Report

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Emerging markets suffer a setback on China worries

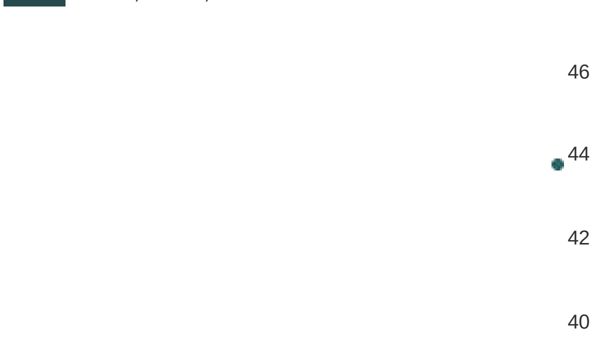
Benchmark ETFs retreat after early 2012 rebound; political risks lurk

By Myra P. Saefong, MarketWatch

SAN FRANCISCO (MarketWatch) — Emerging markets made a sizable retreat in the past month, owing largely to concern over a slowdown in China, but that may hardly dent their prospects as a long-term investment.

"Investors may have been taking some money off the table in what has been an extremely hot asset class out of the gates this year," said Paul Herber, portfolio manager of the Forward Frontier Strategy Fund (MFD:FRONX) (MFD:FRNMX) — and it's happening at a time when "economic news out of the developed world is improving."

VWO **43.79**, -0.17, -0.39%



In March, the Vanguard MSCI Emerging Markets Exchange Traded Fund (NAR:VWO) and the iShares MSCI Emerging Markets Index Fund (NAR:EEM) , which both track the benchmark MSCI Emerging Markets Index, each lost around 3%.

Emerging markets equity funds saw their first weekly outflow of the year during the final week of the first quarter, according to data from RBC Capital Markets and EPFR Global, with outflows of $130 million last week, as of March 28.

"March data revealed that inflows have begun to deteriorate gradually in recent weeks, suggesting that the global economic recovery remains

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on fragile ground, eroding confidence among investors," Nick Chamie, global head of emerging markets research at RBC, said in a note issued Monday.

For the first quarter of this year, however, inflows into emerging markets equity funds saw a solid rebound, "reaching levels not seen since the financial crisis worsened in [the third quarter of] 2011," he said. Data from EPFR Global show net inflows of $25.6 billion for the first quarter.

And year to date as of Tuesday, the VWO and EEM exchange-traded funds both have climbed more than 14%, following a 19% drop last year.

"Emerging markets sold off more than expected in 2011 and investors are generally underweight GEM [global emerging markets]," said Allan Conway, head of emerging markets equities for Schroders. So emerging markets are "well placed to rebound strongly and continue to outperform their developed peers."

Volatility and risk alert

Still, "well placed" doesn't necessarily mean that investors should expect to see the same pace of gains, and analysts continue to recommend an abundance of caution and balance of risk.

"Long term, emerging markets should make up any portfolio, but they have to be balanced with risks, including regulatory uncertainty, corruption which detracts from the bottom line, lack of transparency and other institutional problems," said Usha Haley, professor of international business at Massey University in Auckland, New Zealand and an emerging markets expert.

Chinese demand driving commodities strategy

Minmetals Resources' majority stakeholder is the Chinese government, and the company is bullish that demand from China will continue to fuel the market for copper and zinc.

"Unless balanced with developed markets, emerging markets show too much volatility for single portfolios and often reflect confidence in an associated developed economy, generally the United States," she said.

Economic data from the U.S. has been encouraging. Last month, manufacturers expanded at a faster pace and consumer sentiment reached its highest in more than a year.

Figures from China, however, have been somewhat disappointing. Early last month, China cut its economic-growth target to 7.5% from last year's 8%. Read about China's growth target.

China's official manufacturing survey for March improved to its highest in a year, though a competing survey by HSBC showed the sector moving deeper into contraction. Read about the conflicting data.

"Concerns over a worldwide economic slowdown, not only in China but in the U.S. and Europe … will have the most impact on the more economically-sensitive emerging market countries," said Jeffrey Sica, president and chief investment officer of Sica Wealth Management.

Still, most analysts see concerns over a "hard landing" in China's economy as overstated.

China's Shanghai Composite sank 6.8% last month, Brazil's Ibovespa and India's

"China is still living between two worlds and from time to time pulls back from the modern world, which sends a ripple through their market indices," said Philip Cioppa, host of The Phil Cioppa Show, a nationally syndicated radio show that discusses global concerns and their impact on personal finance. But "the Chinese concern right now should not be seen as a lasting problem that the Chinese can not surmount."

Risk factor

Of course, uncertainty and risk go hand in hand.

Sensex each lost 2% and Russia's RTS fell 5.6%

Chief risks facing GEMs largely stem from the developed world, said Schroders' Conway, adding that the sovereign debt situation in developed Europe has been one of the most publicized of these.

Emerging markets generally have low exposure to developed Europe but "the impact of any deterioration in developed Europe is likely to be seen through increased risk aversion and a risk-off trade," he said, explaining that heightened global market risk aversion could lead to U.S. dollar strength, which traditionally weighs on commodity and GEM returns.

A potential worsening of the situation in Iran also marks a "further potential headwind" for GEMs, given that "energy exporters in GEMs and the Middle East are some of the chief beneficiaries from increasing production to compensate for supply constraints in Libya and Iran, together with benefitting from elevated energy prices," said Conway.

Another wildcard for the market is "the political change currently underway," said Sharath Sury, founder of the Sury Initiative for Global Finance & International Risk Management at the University of California, Santa Cruz.

There are upcoming elections in India, South Korea and Taiwan, and new leadership regimes in China and Hong Kong, though "in general, these should lead to stronger coordinated policies supporting growth," he said.

Against that changing backdrop, this market has "clearly been more volatile at any sign of trouble," according to Sica, with investors "much quicker to sell after being down last year."

"In uncertain markets, the appreciation up to March gave investors a chance to break even rather than risk another downturn with the high levels of uncertainty," he explained. "Break even represented a good time to sell."

Still strong

Equities, in China, as well as Brazil, Russia and India, clearly buckled.

Among the benchmark equity indexes, China's Shanghai Composite (SHA:CN:000001) sank 6.8% last month, Brazil's Ibovespa (SAO:BR:BVSP) and India's Sensex (BOM:IN:1) each lost 2% and Russia's RTS (RTG:RU:RTS) fell 5.6%.

The decline in the Shanghai index "doesn't bode well for the continuation of the risk-on rally" that began in October, said Wojtek Zarzycki, chief investment officer of Optimal Investing. The fall "could imply a shift from emerging market economies to the U.S. markets as the data from the U.S. has been strong and the equity markets have been equally strong."

But "this would be a temporary shift in assets, not a permanent one," he said.

Despite monthly losses, most equity indexes in emerging markets trade strongly higher year to date, with benchmarks in Brazil up 13%, Russia up 22% and India up 14%, while China's has added a modest 2.9%.

"With no looming budget crisis in the U.S., and with some resolution in Europe on the debt issues, a politically-induced depression has been alleviated," said Dennis Quinn, professor of economics at Georgetown University's McDonough School of Business. And "presumably, emerging market companies will benefit from global recovery and from avoiding various debt crises."

As for which nations most likely to benefit the most in the months to come, China and Brazil are standouts.

"China is still a great investment," said Zarzycki, and "Brazil is a great growth story with its surplus of commodities and growing middle class and the World Cup and Olympic Games coming to showcase the country."

But SIGFIRM's Sury warned that although Brazil appears resilient, it is "heavily export dependent upon growth in other regions and ... subject to commodities price volatility." Read about where in LatAm to invest.

Karim Rahemtulla, emerging markets/options director at Wall Street Daily, said smaller economies that are "periphery nations" to China and even India to some extent, have the best prospects going forward.

"They benefit from the crumbs," he said, adding that places like Sri Lanka, Bangladesh, Cambodia, Laos and Vietnam "will be beneficiaries of regional interest."

As for the markets to avoid: watch out for countries which are experiencing capital flight, like Argentina, which is most likely going to devalue the peso in coming months, said Rahemtulla.