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QUARTERLY MARKETS REVIEW

Emerging Markets Propel Global Rebound

Investors Hungry for Returns and Prospects for Growth Lead India (+49%) and Shanghai (+25%) to Big Gains

BY ANNELENA LOBB

Jason Schneider

Stocks rose around the world in the second quarter, particularly in emerging markets. But investors worry about a pullback if the global economy continues to struggle.

Quarterly gains in developing countries such as Russia and China beat stocks in the U.S., France and England. In June, some global markets dipped as doubt crept in ahead of second-quarter earnings reports, and as investors reconsidered whether gains reflected fundamental economic improvement or just relief that the worst-case scenario hadn't panned out.

"I would call what is going on right now a bear trap," said Jonathan Auerbach, managing director at international brokerage Auerbach Grayson. "Markets got very oversold, there were huge short positions, tremendous amounts of liquidity being provided to markets, and a sense from investors that they may have missed it, so they needed to participate."

China's benchmark Shanghai index gained 25% in the second quarter, and Brazil's was up 26%, compared with a rise of 11% in the Dow Jones Industrial Average and gains of 8.2% in the U.K.'s FTSE 100.

At the start of the quarter, emerging markets already were moving higher, as the outlook for the Chinese economy improved and as the Group of 20 industrial and developing nations decided to give more money to the International Monetary Fund to handle financial crises. An index tracking emerging markets rose 34% in the latest quarter, in dollar terms, through Monday, according to MSCI Barra.

A research report from Citigroup Inc. during the quarter forecasted economic growth, not adjusted for inflation, of 5.8% in 2009 in emerging markets, compared with a decline of 4.7% in developed markets.

"There may be values in developed markets, but they look less attractive, because the growth profile of many emerging-market countries is higher and valuations are similar or cheaper," said Rob Lutts, chief investment officer at Cabot Money Management in Salem, Mass.

Stocks in India surged in the second quarter. Its benchmark Sensex index gained 49% over three months. India's mid-May election results, which brought a strong victory to the ruling Congress party and its allies, helped stoke investor optimism.

Eastern Europe also saw big rallies. The Budapest Stock Exchange gained 38% and Poland's WIG-20 gained 23%. In that pocket of the world, "the challenge is that debt problems are still there," said Stuart Schweitzer, global markets strategist at J.P. Morgan Private Bank.

Much of the region has struggled with subprime-debt problems similar to those experienced in the U.S. and U.K. In Eastern Europe, those issues were exacerbated by the fact that many loans were made in euros or Swiss francs to borrowers whose local currencies also lost value. European banks that hold those loans could get hurt in a ripple effect. A few weeks ago, Swedish banks "took a major hit" after a failed debt auction in Latvia, Mr. Schweitzer said.

"There's going to be a lot more economic activity in countries where people want to own their first house, their first car and so on," said Paul Sutherland, president and chief investment officer at FIM Group in Traverse City, Mich. "But those markets are hugely influenced by capital flows. The U.S. and Europe get hugely excited, move money in, valuations go up to levels that are ridiculous and then they pull it all out again."

This year, cash inflows into emerging-market stock funds have returned more than half the outflows in 2008, according to a Citigroup report.

Among developed markets, Japan was a top performer, with a rally that beat gains in the Dow industrials; also the U.K., France and Germany. In the second quarter, Japan's Nikkei Stock Average of 225 companies gained 23%. Japanese shares still look cheap, "even after the rally," said Taizo Ishida, lead portfolio manager for the Matthews Japan Fund. Just over 60% of the companies in Japan are trading at prices below their book values, he said.

The largest markets in developed Europe were "the notable laggards" compared with emerging markets, said Larry Glazer, managing partner at Mayflower Advisors in Boston, Mass. The idea that Europe entered the global downturn later and thus isn't as far along in its recovery as the U.S. hindered some of those markets, he said.

"The consensus on Wall Street has moved back to emerging markets and China, and that Europe will lag," Mr. Glazer said. "The most contrarian call you can make right now is that Europe will outperform."

Even so, indexes in the U.K. and France snapped seven-quarter losing streaks, and Germany broke a five-quarter losing streak. France's CAC-40 index gained 12%, and Germany's DAX index added 18%.

In developed European markets, "we saw a dash to trash," said Jonathan Stubbs, managing director and senior strategist for Citi's European equity strategy team. The leaders were high risk, "had weak balance sheets and had traded very cheaply." Many investors sold holdings in more-defensive sectors, such as consumer staples, to move money into riskier positions. In Europe, the switch has left stocks in sectors such as consumer staples, telecoms and utilities looking cheap, he said.

"Over the last couple months, the end of the world has been priced out, and there have been some signs of stabilization, but recovery hasn't been priced in," Mr. Stubbs said.

Overall, the second quarter brought "a global sigh of relief that we are evidently not falling into a bottomless pit," said J.P. Morgan's Mr. Schweitzer, as well as relief that cutbacks to global production had reversed the buildup of inventories that occurred last fall and winter.

Global Gains

Three stock-market indexes in the second quarter

— Brazil/Bovespa: up 26%
— China/Shanghai Composite: up 25%
— U.K./FTSE 100: up 8.2%

Source: Thomson Reuters via WSJ Market Data Group

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