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Emerging Markets are Cheap But Cheap Enough to Buy?

Almost one month ago, I noted that emerging markets were cheap, William Blair & Co. answers that question with a yes.

In a report that hit my inbox–and that of at least four colleagues–today but dated July 10, William Blair portfolio manager Todd McClone explains just how cheap emerging-market stocks really are:

Currently on one year forward earnings, emerging markets have a P/E ratio of approximately 10x. Developed markets are at about 13.1x. To put emerging markets' 10x P/E ratio in context, at the bottom of the recent global financial crisis in March 2009, emerging markets traded at 8x earnings. And the P/E range for the last ten years has been between 8x – 18x. Clearly, emerging markets are at the bottom end of that range and are pricing in poor growth and, to some extent, some kind of crisis.

Going back as far as 1990, the historical emerging markets P/E discount has approximated 20% relative to developed markets versus the current 30%. A significant amount of bad news has been priced into emerging markets equities at these levels, given the nearly crisis valuation.

A crisis, however, won't be forthcoming, McClone says.

The good news is that compared to the major emerging markets crisis periods in the early 1980s and mid-1990s (e.g.,The 1994 Tequila Crisis and the Asian Financial Crises), there are a few points in emerging markets' favor that can help avoid a repeat of these crises. First, sovereign leverage is far lower as emerging markets' fiscal balance sheets are in great shape (and clearly in much better shape than developed markets sovereign balance sheets). Second, the extent of external debt positions in emerging market countries is far lower than in previous times. Third, emerging markets' central bank reserves are far higher now than they were in previous crises, giving them more flexibility to deal with emerging markets fixed income outflows. Finally, the current account positions are generally in much better shape than they were in previous crises, giving a buffer for current volatility.

His biggest worry:

The differential between the economic growth of emerging markets and developed ones. Developing economies, for instance, are forecast to grow at a 5.2% clip, while developed ones should grow by just 1.3%. The emerging market forecast, however, has dropped from 5.8%, while the developed market one has been boosted from 0.8%. Why is this important? In the past, emerging markets have outperformed when they had growth momentum relative to developed ones.

"This is clearly not the case at the moment and is unlikely to be so for the duration of 2013 and possibly into the beginning of 2014," McClone says.

The iShares MSCI Emerging Markets Index ETF (EEM) has gained 0.7% to $39.53 today, while the Vanguard FTSE Emerging Markets ETF (VWO) has risen 0.7% to $39.83. The iShares FTSE China 25 Index (FXI) has dropped 0.3% to $33.62, while the WisdomTree India Earnings ETF (EPI) has ticked up 0.4% to $16.78.