







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Monday, September 24, 2007

⌚ ⌚ ⌚ Rate Cut Spurs Emerging Mkts

From WSJ 09/20/2007

Now that the fallout from the downturn of the housing-loan market has prompted the Federal Reserve to cut interest rates, the race is on to find the next bubble.

Emerging markets are a popular answer.

Stock markets around the world rallied in response to the Fed's half-percentage-point cut on Tuesday, with shares in emerging markets -- generally defined as countries that have modest incomes but are growing fast -- posting the biggest gains. Mexico's benchmark IPC index on Tuesday rose 2.8% and Brazil's Bovespa rose 4.3%, trumping the Dow Jones Industrial Average's 2.5% gain.

Yesterday, Asian markets, which had been closed when the Fed announced its rate cut, joined the party, with India's Bombay Sensex climbing 4.2% to cross 16000 for the first time.

The rush into emerging-market stocks is in part because of a belief that the Fed's rate cut, as well as easier policy stances at the European Central Bank and the Bank of England, will end up bolstering fast-growing emerging-market economies more than any others. Proponents of this view say that in 1998, easy money flowed into fast-growing technology stocks following the Asian financial-market crisis and collapse of the hedge fund Long-Term Capital Management. The belief that tech stocks were immune to any downturn helped fuel the dot-com bubble.

'It's like 1998 in reverse,' says Michael Hartnett, an emerging-markets strategist at Merrill Lynch. 'A bubble is more likely than not. But I think we're only at the beginning of that process.' He is bullish on emerging markets as a result.

Mr. Hartnett isn't the only one to draw the 1998 analogy, or point to the possibility of a bubble developing.

A month ago, Morgan Stanley emerging-markets strategist Jonathan Garner wrote that the current market environment is 'the mirror image of 1998.' In early August, Christopher Wood, a Hong Kong-based analyst at CLSA Group, wrote that 'just as, first, American tech stocks and then American housing finance were bubble beneficiaries of Fed easing post-LTCM and

post-Nasdaq collapse, so Asia and emerging-asset markets will be the likely bubble beneficiaries of the coming Fed easing.'

A key reason emerging markets have become so attractive is that they have posted robust economic and earnings growth even amid rising U.S. interest rates. This suggests that their economies have become less volatile and that their shares should carry higher valuations.

And, in fact, stocks in emerging markets, long less costly than their developed-market counterparts, are becoming pricier. At the end of last month, the stocks that make up the MSCI Emerging Markets index were trading at 17 times their earnings for the prior 12 months. In comparison, the stocks in an MSCI index that tracks developed markets other than the U.S. and Canada were trading at 15.3 times earnings.

Bulls on U.S. home builders made a similar point after the housing market remained robust through the 2001 recession. They argued that home-building stocks -- traditionally highly cyclical -- deserved higher valuations than in the past since the companies had broken out of the cycle. And just as with the home builders, everyone isn't convinced that emerging markets have escaped their dependence on the U.S.

'Maybe the Fed is cutting so aggressively because they know something about growth in the U.S. falling off a cliff,' says Arjun Divecha, a portfolio manager at GMO LLC who oversees more than \$20 billion in stocks in emerging markets. 'That can't possibly be good for emerging markets.'

But emerging markets, at least so far, have been remarkably well-shielded from the downturn in the U.S. housing market and the credit troubles that have ensued. Gustavo Dolfino, president of WhiteRock Group, a Wall Street executive recruiter, says he got worried about frothy U.S. credit markets six months ago and decided, 'I had to hedge myself.'

He turned to Asia, opening offices in Shanghai, Singapore and Hong Kong, where he has been placing bankers and traders into derivatives jobs. He says he will bring in at least \$10 million to \$15 million in revenue in each office, exceeding his expectations. 'I hired a recruiter to help us find more recruiters,' he says.

What is striking, says Investment Technology Group economist Robert Barbera, is that the idea that there could be a bubble on its way in the emerging markets is a cause for glee rather than caution. 'Very few people are saying, 'Oh my God, it's a bubble," he says. 'They're saying, 'Whoopee, it's a bubble.'

Investors' enthusiasm to get in early on the next bubble may come down to human nature. In market experiments conducted by Vernon Smith, a George Mason University professor who shared in the 2002 Nobel Prize for economics, participants invested in a dividend-paying 'stock' with a clear fundamental value and a bubble invariably formed. If the experiment was repeated, the bubble would form again -- and participants would say they were surprised they couldn't get out before the collapse.

'The thing about bubbles is that they're rather fun when you're in them, since you're making a lot of money,' says Julian Mayo, investment director at Charlemagne Capital, a London firm that manages \$5 billion in emerging-market stocks. 'If one thinks a bubble could emerge, you want to fill your boots with the sector, as long as you get out when valuations are overstretched.'

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