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STREETWISE

Buy Turkey and Argentina? Emerging Markets Aren't Bargains They Seem

There are times when a pure contrarian investing approach makes sense, but today is not such a time



The falls of roughly half in the Turkish and Argentinian currencies against the dollar this year have helped drag down the currencies of even countries such as India and Indonesia PHOTO: LEFTERIS PITARAKIS/ASSOCIATED PRESS



By James

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Emerging markets look increasingly chaotic, with plummeting currencies, messy politics and the biggest-ever IMF bailout capturing headlines.

Emerging stocks appear far cheaper than in developed countries, especially compared with the pricey U.S. market. So is now the time to close your eyes to the headlines, ignore the sick feeling in your gut and just buy?

Frankly, no. There are times when such a pure contrarian approach makes sense, but today is not such a time. True, the MSCI Emerging Market index trades at just 11 times estimated earnings for the next 12 months, against almost 17 times in the U.S. True, the falls of roughly half in the Turkish and Argentine currencies against the dollar this year have helped drag down the currencies of even countries such as India and Indonesia with better-balanced economies. True, the biggest emerging equity market, China, is back in a bear market, and so are emerging stock indexes with big China exposure.

Yet, neither emerging equities nor the major emerging bond indexes have even given back all last year's gains and income, let alone dropped to true bargain prices. Valuations aren't especially low by historical standards. Worse, the index only looks inexpensive because it is weighted toward sectors few want to buy, even in developed markets.

The last point is perhaps the least understood. Emerging markets have far more banks and commodity producers, which trade at lower valuations than more fashionable areas. Adjust sector weights to match those of developed markets and emerging market indexes trade at the same price-to-forward-earnings ratio as the FTSE World index, according to Philip Lawlor, FTSE Russell head of global markets research.

Investors hoping to take advantage of the turmoil to buy into the emerging middle class at a discount through one of the plethora of emerging exchange-traded funds will be disappointed. Almost half the cheapest 25% of decent-size emerging stocks—those worth more than \$1 billion

—are in the financial sector, including many Greek, Turkish and Chinese banks. Many of the rest are in low-growth utilities or Russian oil. Only 8% of these low-valuation stocks, measured by price-to-book ratio, are in consumer sectors, and none at all in health care.

The most-expensive emerging stocks look quite different. Half are in the consumer and health care sectors, which have higher valuations than the same sectors in developed markets excluding the U.S. By market value, the biggest stocks by some distance are the major Chinese technology firms, which are also expensive even after hefty falls this year.

“Looking at the PE [price/earnings ratio] of the emerging markets index will lead you astray,” says Christopher Smart, head of macroeconomic and geopolitical risk at Barings. “A lot of the index is global tech and global commodity cycle, much more than it is the emerging middle class.”

The lack of widespread emerging-market bargains still leaves open the idea of searching for opportunities in the hardest-hit countries. The trouble is that Turkey and Argentina are both struggling with heavy dollar debts; devaluation helps deal with the problem of too many imports and too few exports, but makes it even harder for the Argentine government and Turkish banks to pay their debts.

Investors who think the problems will be solved without defaults can find plenty of Turkish bank stocks trading at less than half book value, with four-year dollar bonds yielding 20%-plus. The Argentine 100-year dollar bond yields more than 10%, again making the brave assumption of no default.

Recent history suggests buying stocks after a big devaluation often works out, as it did after Mexico's 1994 Tequila crisis, the 1998 Russian default or even the Argentine default of 2001. But success depended on timing, much of which is luck. An investor who put dollars into Argentine stocks at the start of 2002, immediately after the default, lost half their money within six months. Those who waited until July tripled their money in dollar terms in the next 18 months.

Recent history might be misleading. Most big devaluations in the past came when pegged exchange rates were abandoned, so there are few examples of falls in floating currencies as big as Argentina's or Turkey's to use as a guide. The political repercussions are tough to predict, but capital controls are entirely plausible, and would make it hard to realize any gains.

Investors should accept that in emerging markets right now, where assets are cheap they are cheap for good reasons. Disagree with the reasons after hard analysis, sure, but this is not the time for simple-minded contrarian buyers.

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