POINT VIEW

INVESTING QUARTERLY

What's ahead for emerging-market stocks?

Investors expecting an immediate recovery in emerging-market stocks may be disappointed, some experts say.

By Walter Hamilton

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For most of this year, the emerging markets have felt more like the submerging markets.

Developing countries such as Brazil and India have gone from being the object of intense investor affection to the albatross of the global stock market.

After years of outsized investment performance, the developing world lagged badly in 2013. The MSCI emerging-market index has fallen 4.5% this year even as the Standard & Poor's 500 index has jumped 18.5%.

Emerging-world stocks rallied last month after the U.S. Federal Reserve delayed the expected tapering of its stimulus program. The sector also got a boost from signs of economic stabilization in China.

But investors expecting an immediate recovery in emerging-market stocks — or a return to the outsized gains of the past — may be disappointed, some experts say.

Developing countries are grappling with a variety of troubles. Economic growth has slowed. Commodity prices have sagged. And currencies have weakened.

Even with last month's rally, the MSCI remains below its 2007 peak. It basically has traded sideways for four years.

"The emerging-markets story is noticeably tarnished," said Alan Gayle, chief investment officer at RidgeWorth Capital Management. "It's one of those stories that I'm perfectly happy to sit on the sidelines and observe. I would say there are better opportunities in the developed markets."

Bulls acknowledge the challenges but say the developing world has several factors going its way long-term.

"Emerging markets have faster growth and the stocks are cheaper," said Laura Geritz, manager of the Wasatch emerging-markets small cap fund. "Over the long run, you should have better returns in these markets."

Financial maturation has made developing nations much less vulnerable to the sort of crises that hobbled them in the 1980s and 1990s. And there's little doubt they'll continue to grow.

A report last week by the McKinsey Global Institute, for example, projected that as many as 229 of the world's 500 largest companies could be based in emerging countries by 2025, up from 85 in 2010.

For investors seeking exchange-traded funds, two of the best-known are the iShares MSCI emerging-markets ETF [ticker: EEM] and the Vanguard FTSE emerging-markets ETF [VWO].

Skeptics, however, worry that the developing world has hit the economic equivalent of adolescence.

Emerging markets took flight from late 2002 through late 2007 thanks to steady U.S. growth and blistering expansion in China. Huge demand for oil and other natural resources turned Brazil and Russia into virtual commodity plays.

The biggest markets — Brazil, Russia, India and China — came to be known by the catchy acronym BRICs.

But emerging nations rely heavily on exports, and the economies of the developed world remain sluggish in the aftermath of the 2008 financial crisis. That makes it unlikely that the developing world can reclaim the high-torque growth of the past.

The International Monetary Fund projects that the developing world will expand 5% this year. That's down from an estimate of 6% in April 2012. Emerging countries grew 4.9% last year, down from 8.8% in 2007.

"People still think of them the way they were from 2003 to 2008, and you really need to understand the exposures and risks today," said Geoffrey Stewart, a portfolio manager at Aristotle Capital Management in Los Angeles.

Partly because of reduced economic growth, valuations haven't declined much from their long-term averages.

Based on 12-month projected profits, the price/earnings ratio of the MSCI index is 10.5, compared with a five-year average of 10.8 and a 10-year average of 11.1, according to FactSet Research Systems.

Investors could benefit from the burgeoning middle classes in countries such as Brazil, Turkey and Mexico. That's boosting demand for consumer goods ranging from air conditioners to luxury cars.

But adolescence is a slow and uneven process.

Anemic growth and low interest rates in the U.S. in recent years sent investors pouring into emerging markets in search of higher returns. That masked problems in many countries. Those include inadequate infrastructure, poor education and health services, and government corruption.

"There are opportunities within these markets, absolutely," said Sean Thorpe, an Aristotle portfolio manager. "They're not as easy to find as you would think."

An immediate threat to the emerging markets is the political logjam in Washington. Economists warn that a U.S. government debt default later this month could throw the global economy into disarray.

Beyond that is the expectation that the Fed will soon start pulling back its economic stimulus, perhaps later this year. That could damp economic growth in the developing world and rattle investors.

Emerging-market securities tumbled over the summer when Fed chief Ben Bernanke hinted that the central bank was likely to pull back on stimulus. Indonesia, Brazil and Turkey raised interest rates to stem capital flight, despite the risk to their economies.

China remains the linchpin for the developing world, though its growth prospects have made investors jittery.

The Chinese government is targeting a 7.5% growth rate this year. That towers above the 1.7% expected in the U.S. but is down from 14.2% in 2007, according to the IMF.

After a slowdown earlier this year, recent data have allayed some fears about the Asian giant. Chinese exports rose 7.2% in August from a year ago, up from 5.1% in July and a decline of 3.1% in June. Industrial output rose 10.4% last month, the best since March 2012.

But investors question whether Beijing can succeed in its stated goal of fostering a consumer-driven economy. The government has said it wants to steer the country away from its dependence on exports and huge domestic infrastructure projects.

There also are concerns about the fate of China's super-charged housing market.

The uncertainty has crimped other BRICs, especially Brazil, which is a major supplier of commodities, such as iron ore, to China. Brazil's GDP slid to 0.9% last year from 7.5% two years earlier.

India, meanwhile, is plagued by inflation, budget deficits and a shrunken currency.

Despite the problems, some analysts say emerging markets are worth consideration.

"Near-term I don't see anything to change the downward pressure on the emerging markets because we could be in the early innings of an improving [U.S.] economy and diminishing monetary stimulus," said David Dietze, investment chief at Point View Wealth Management in Summit, N.J. "But longer-term valuations are far more attractive, so for long-term investors it's worth considering."

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