

An Introduction to Emerging Markets

1.1 INTRODUCTION

Two first-time authors would have to be very brave – or indeed very foolish – to challenge the wisdom of revered investor and mutual fund pioneer Sir John Templeton. The founder of the company that, incidentally, went on to employ legendary emerging markets investor Mark Mobius, famously said: “The four most expensive words in the English language are ‘This time it’s different’.”

Thus, for example, investors who bought into the technology, media and telecoms boom of the late 1990s just before that particular bubble burst will be painfully aware that, that time, it certainly wasn’t different. They probably won’t be too impressed either with the two words “new paradigm” that were bandied around by technology champions as the argument that trumped all doubters.

But are not evolution and change – the possibility that, this time, it really is different – part and parcel of the whole business of investing in emerging markets? Surely investors buy into the emerging space to tap into the growth that, at least in part, accompanies a country’s journey from nascent or frontier market to fully paid-up member of the global economy.

And if change is indeed an integral part of the emerging markets story, should we not at least consider the possibility – as this book intends to do – that the global financial crisis, which began in earnest when investment bank Lehman Brothers filed for bankruptcy on 15 September 2008 and very much had its roots in the Western financial system, may have closed the credibility gap between the emerging economies and those of the developed world?

That is just one thread – albeit a crucial one – of a book that will also look to identify what emerging markets actually are while weighing up their attractions as an investment. It will take a long hard look at the associated risks, before considering the pros and cons of different regions and individual economies around the globe. Along the way, it

will also consider what part emerging markets can play in an investment portfolio and the various routes an investor can use to gain access to them.

1.2 WHAT ARE EMERGING MARKETS?

Whether they be professional or operating on their own time, investors have a tendency to see things as two sides of the same coin. So, for example, they may look to invest for income or growth, in large corporations or smaller companies, in equities or bonds, or with an active fund manager or through a passive, index-tracking investment. The way they see the globe is no exception and, in this regard, the most fundamental distinction made is between the developed world and the so-called emerging markets.

At their broadest – taking in Africa, Asia, Eastern Europe, Latin America and the Middle East and thus individual countries as diverse as, say, Nigeria, Singapore, Hungary, Venezuela and Jordan – the emerging and frontier markets do not really lend themselves to a nice and easy soundbite of a definition. Even listing them is not exactly straightforward with the major stock market index providers unable to agree exactly on which countries count as emerging markets.

At the start of 2010, FTSE, MSCI Barra and Standard & Poor's overlapped on 19 countries in their main Emerging Markets indices with China, India, Indonesia, Malaysia, the Philippines, Taiwan and Thailand representing Asia, Brazil, Chile, Mexico and Peru for Latin America, the Czech Republic, Hungary, Poland, Russia and Turkey for Europe and Egypt, Morocco and South Africa for Africa.

However, Argentina, Colombia and Pakistan are also included in the FTSE Emerging Markets index, Colombia, Israel and South Korea feature in the MSCI Emerging Markets index and Argentina, Israel and South Korea bolster the S&P/IFC Emerging Markets index.

Nevertheless, rather than giving up so easily and settling for defining emerging markets by what they are not – for example, the “advanced” or “developed” economies of the US, Western Europe and Japan – which is not very helpful, or by terms such as “Third World”, which borders on the patronizing, a more useful approach might be to outline some benchmarks by which to judge a country's level of maturity.

These could include a country's growth rate – possibly the most attractive aspect of the emerging markets space over the years – in addition to the size and openness of its economy, the degree to which it

is integrating within the global marketplace and the strength or otherwise of its political, legal and financial institutions.

The average level of income per citizen is another revealing factor as it is an indication of how far a country's standards of living are improving and whether the middle class, which is now seen by most commentators as a vital driver of any emerging market's internal economy, is growing.

Through its very make-up, therefore, an emerging market offers a mix of reward and risk and it is up to investors to judge how well these two elements are balanced. The rewards will stem from the potential for growth as the country develops as a nation and as an economy, both internally and in relation to the rest of the world. Meanwhile the risks will come as a result of a lack of political or economic stability or uncertainties stemming from a vulnerability to other internal and external forces.

"The risks are inherent in the question of what an emerging market is," says Richard Titherington, chief investment officer and head of the emerging markets equity team at J.P. Morgan Asset Management. "In my view, an emerging market is a country that has – and there are a lot of different reasons why this may be the case – a much higher degree of political and financial risk and instability than you get in the relatively small group of countries that we regard as developed."

The emerging markets can be split into four regions – Asia, Emerging Europe, Latin America and the so-called "frontier" markets, which are broadly to be found in Africa and the Middle East. All share certain general attractions for investors – and carry certain general risks. These are discussed in the next chapter but naturally they also have pros and cons that are more specific to a region or country and that is why we address the various emerging markets in six chapters grouped by geography.

Again, at their broadest, emerging markets represent some four-fifths of the world's population and almost three-quarters of its land mass. At the start of 2010, they accounted for roughly 70% of global foreign exchange reserves, more than half of global energy consumption and close to half of both the world's exports and, in purchasing power parity terms, its gross domestic product – the market value of all the goods and services produced by a country and known for short as "GDP".

Towering over everything else in the sector is the colossus of the emerging markets world known as "BRIC" – a term coined in 2001 by investment bank Goldman Sachs to cover the four biggest developing nations of Brazil, Russia, India and China.

According to the International Monetary Fund, China was the third largest economy in the world in 2008 with GDP of \$4.3 tn – closing in on Japan on \$4.9 tn but with still some way to go to catch up with the US at \$14.4 tn. By the same measure, Brazil was the eighth largest economy in the world, Russia was 11th and India 12th. However, with the International Monetary Fund, as of October 2009, predicting China's GDP would grow by 9% in 2010 while that of the US would grow by 1.9%, the former looks set to be breathing down the US's neck within a decade or two.

For its part, Goldman Sachs is projecting that in 2050 the new world order will see China dwarfing every other economy in the world with GDP of \$70 tn, with the US second on \$40 tn and followed by India, Brazil, Russia, the UK and Japan – with China expected to surpass the US in 2027.

Together, the BRIC quartet are the flagships of the three main emerging market regions and, at the risk of oversimplification, encompass two of the globe's most powerful economic themes. China and India are two of the world's strongest domestic demand growth stories with a massive appetite for all kinds of natural resources. Neatly enough, Brazil and Russia are both leading exporters of natural resources.

Asia offers the broadest spread of emerging markets, both in terms of numbers and diversity. China's influence as a global economic superpower grows daily and the increasing spending power of India's burgeoning middle class offers great hope to investors. Meanwhile the positive example of more mature economies such as Hong Kong, Singapore and South Korea stands as a real incentive for neighbours who have not progressed as far along the development path, such as Indonesia, the Philippines and Vietnam.

Eastern Europe is dominated by Russia, whose fortunes are strongly dictated by the price of oil. The investment case for the rest of the region generally focuses on whether or not and to what extent individual countries would meet the necessary economic and financial criteria for membership of the European Union and, ultimately, the adoption of the euro – the so-called “convergence” play. Some, particularly the Baltic countries such as Latvia, have expanded too fast and consequently suffered as a result of excessive debt levels.

Latin America is also dominated by one country, in this instance Brazil, which arguably may be seen as offering the best of all BRIC worlds. Not only is it a leading exporter of commodities, such as oil and

agricultural products, it is also an increasingly sophisticated economy that is expected to thrive on growing consumer demand.

Across the border, however, Argentina stands as a stark warning that not all emerging markets – no matter how large they may be, how sophisticated their population and infrastructure, how many advantages they may enjoy such as, for example, a rich supply of natural resources or how much foreign investment is ploughed in – necessarily live up to investor expectations.

The frontier markets are the latest wave of emerging economies to appear on investors' radars and are often plays on the ongoing global demand for commodities – for example, oil in Nigeria or mining in South Africa. Very much a case of achieving potentially high reward for assuming a commensurately high level of risk, frontier markets might usefully be viewed as a bull market phenomenon where people become less discerning as their appetite for risk grows. Often they can end up investing too late in an economic cycle.

Interestingly, although they suffered in terms of, for example, reduced exports, many emerging markets avoided becoming direct victims of the global financial crisis. This was partly because they were not so reliant on the Western banking system, which bore the full brunt of the crunch, and partly because, having suffered their own market meltdowns, such as the Asian crisis of 1997, governments and companies had learnt some valuable survival lessons.

1.3 A BRIEF HISTORY OF EMERGING MARKETS

For such a well-worn expression, the origins of “emerging markets” as a term are a little fuzzy although consensus now has it that it dates back to the 1980s and the International Finance Corporation. That was where Antoine van Agtmael, who is now chairman and chief investment officer of investment house Emerging Markets Management, was working as deputy director of the Capital Markets Department when his book *Emerging Securities Markets* was published in 1984.

Four years later, the International Finance Corporation became the first organization to launch a dedicated emerging markets index, which along with its entire Emerging Markets Database was acquired in 1999 by Standard & Poor's.

While we are on the subject of emerging markets terminology, the derivation of the other key grouping, the “BRIC” economies, is more certain. Credit for the acronym goes to investment bank Goldman Sachs,

which published its paper “Building better global economic BRICs” in November 2001 and has remained at the forefront of thinking on the subject ever since.

The term “emerging markets” may date back only as far as the 1980s but the spirit of the concept can be traced back a good deal further. Arguably China and India, the two most populous countries on the planet, are merely in the process of returning to centre-stage, having dominated the global economy in terms of share of GDP for pretty much all of the last millennium bar the 20th century.

In a neat reversal therefore, that leaves the US as the archetypal emerging market – or, at the very least, an instructive parallel with the emerging markets of today. There is a line of thought that, if you really want to tap into the growth of an emerging or frontier market, then you shouldn’t invest there. Rather you should go and live in one – if you’re very optimistic about Cambodia, don’t buy a Cambodia fund, go and open a restaurant or a hotel in Angkor Wat.

It is certainly a theory and one that – always assuming you are still reading and haven’t dropped this book to pick up the phone to your travel agent – held true for the US in the 19th century, where one was generally better off going to live than investing through, say, a UK institution buying US assets. A catalogue of setbacks that will be familiar to any seasoned emerging markets investor – including civil war, currency crises, banking collapses, failures of infrastructure, scams and scandals – meant investors in the US endured a rough ride for a significant time.

For long periods, it was a very tough place to be a financial investor although, of course, ultimately, the country was fantastically successful and those who predicted the US would be the next big thing were utterly vindicated. As professional investor and financial commentator Jim Rogers once said: “If the 19th century belonged to Britain, and the 20th century to the United States, then the 21st century will surely belong to China.”

1.4 A TALE OF TWO DECADES

Since their, well, emergence in the 1980s as an investment asset class in their own right, the emerging markets have experienced two distinct phases. The first was the boom and bust in the 1990s, when the loose monetary conditions of the first few years of the decade brought foreign

investors flocking to the space before a number of spectacular crises sent them running for the exits just as quickly.

Ironically, it is partly because the first phase led to such pain that emerging markets could show such robust growth in the second phase, which really kicked in around 2004 and has been characterized by a period of extraordinary growth led by the industrialization of China.

The first phase followed the discovery of emerging markets by institutional and then private investors. In the mid-1980s, institutional investors, such as pension funds, began to search for investments that were less correlated – that is, moved less in line – with their existing assets at the same time as a number of developing markets began to hit their economic stride, including the four so-called “Asian tigers” of Hong Kong, Singapore, South Korea and Taiwan.

As equity values started to soar, investors’ appetite for risk increased and a number of investment funds were launched that specialized in emerging markets. The early performance was strong, although trading volumes remained thin and, for the time being, private investors were largely uninterested.

Problems started to emerge as early as 1989 as interest rates rose and the global downturn began, but it was not until 1994 and the Mexican peso crisis – which also dented confidence across South American markets, including Brazil – that the economic travails of the emerging markets began in earnest.

In 1997, with the Mexican crisis – also more colourfully known as the Tequila Crisis – still fresh in investors’ minds, Thailand was forced to devalue its currency, the baht, and over the course of the next year the “Asian contagion” spread across the continent as the tigers and their neighbours were well and truly tamed. The Asian financial crisis and ensuing slump in commodities prices, which hit countries reliant on exporting resources, then prompted the Russian debt crisis in 1998.

The central themes of these crises will not be unfamiliar to any experienced market watcher – the countries involved had borrowed heavily in foreign currency and, when economic problems forced them to devalue their own currencies, they were left with a huge overhang of foreign-denominated debt that it took many painful years of austerity to pay back.

Putting a more positive spin on this, however, one might also say that many emerging markets ended up learning to be very wary of excessive debt levels – a lesson that put them in a relatively strong position in the wake of the global financial crisis.

Around the same time, in Eastern Europe, the Berlin Wall fell and the Eastern bloc countries began to throw off the shackles of communism and embrace capitalism. The European Union immediately started to direct funds towards the area's major economies such as Poland and Hungary to help them to make the transition to market economies – with European Union membership the near-term goal. For investors, this marked the start of the “convergence” trade as countries in the region moved closer to Western European living standards and incomes.

For much of the late 1990s and the early part of the next decade, however, most emerging markets found themselves very short of friends. The domino effect of currency devaluations and economic crises had finally concluded with the Argentine peso devaluation in January 2002, but no one felt inclined to invest and most were directing any appetite for risk towards the burgeoning technology, media and telecommunications sector. After the resulting “tech bubble” burst in 2000, this appetite again disappeared.

Cometh the hour, cometh the Mandarin and it was about this time that investors began to pick up on the vast potential of China. In truth, China's modern growth story went back as far as 1978 when Deng Xiaoping set about instituting free market reforms and seeking to attract overseas investment. The brutal suppression of the student-led pro-democracy demonstrations in Tiananmen Square in 1989 led Western and Japanese companies to draw back from committing money to China but, soon enough, the trickle of capital turned into a flood.

The handover of Hong Kong in 1997 gave China convenient access to Western capital markets. According to the International Monetary Fund, China began to deliver consistent annual GDP growth of between 10% and 13%, thanks to a combination of its cheap labour force and the opportunity for low-cost manufacturing it offered.

The effects of this growth were felt around investment markets though nowhere more so than in commodities. The industrialization of China created an unprecedented boom in raw materials, particularly oil, which in turn provided a lucrative source of funds to other resource-rich emerging markets – most significantly Brazil and Russia.

This boom was not reflected in the stock markets of the emerging economies until 2004, but when the markets moved, they did so swiftly and decisively – many of them tripling in the period up to their peak in 2007. In the three years to October 2007, the overall MSCI Emerging Markets index rose 175% although this masked some even stronger

growth among individual emerging markets – for example, the FTSE Xinhua B35 index of Chinese companies rose 282% over the same period.

The new-found wealth of many emerging markets was hived off into huge pools of money called sovereign wealth funds, which became a powerful new force in global financial markets but also helped to protect emerging markets when the credit crunch hit.

Although emerging markets largely avoided any problems with their banking systems, they were hurt by the slowdown in their major trading partners as export demand slumped as well as by investors seeking traditionally safer havens for their money. As such, the excess capital built up during the boom years helped them support their economies through infrastructure building, welfare packages and economic stimulus – a notable example being the \$586 bn package of measures announced by the Chinese government in November 2008.

As a result – and with certain exceptions, primarily in Eastern Europe – the bounce-back for emerging markets was far quicker and far more robust than that of their developed market counterparts. Many of these economies did not even fall into recession and their stock markets reflected this – selling off heavily in the last few months of 2008 only to recover quickly the following year as the global economy appeared to get back on track.

The supportive monetary conditions the emerging markets had enjoyed back in the early 1990s returned once again – as did investors who could not resist the attractions of historically low company valuations. These investors would have been hoping the companies of Asia, Latin America and the rest were aware that, in order to avoid a repeat of the second part of the 1990s scenario, they would have to work to ensure earnings underpinned the valuations that naturally increased as a result of the large amounts of money flowing into those markets.

In return, emerging markets companies would be hoping that external money turns out to be a little “stickier” than in previous market cycles and that foreign investors prove less easily spooked than they have in the past. It is in the nature of investment that money is “rotated” from asset class to asset class and from sector to sector while cyclical flows back and forth between the developed and emerging markets will inevitably continue. Even so, are there more structural reasons for believing a smaller proportion of money will desert the emerging markets at the first sign of trouble than has traditionally proved the case? This time, could it really be different?

Some key dates for the emerging markets

- 1988:** The International Finance Corporation launches the first emerging markets stock market index. At the time, six markets were open to investment – Hong Kong, Malaysia, Mexico, the Philippines, Singapore and Thailand.
- 1989:** The Berlin Wall falls and Eastern bloc countries start the transition from communism to free markets.
- 1990:** Deng Xiaoping reopens the Shanghai Stock Exchange, which had been closed since 1949.
- 1991:** Collapse of the Soviet Union.
- 1991:** Following a \$1.8 bn bailout loan from the International Monetary Fund, the Indian government moves to liberalize the country's economy.
- 1993:** Stock markets in Latin America and East Asia enjoy spectacular rallies.
- 1994:** The Brazilian government introduces the Plano Real (Real Plan) in a bid to stabilize the country's economy.
- 1994:** The Mexican peso crisis, also known as the Tequila Crisis, leads to the country's currency being devalued in December. Confidence in South American markets was also dented as a result.
- 1997:** The sovereignty of Hong Kong transfers from Britain to China, giving the latter convenient access to Western capital markets.
- 1997:** Thailand is forced to devalue its currency. After 10 years of strong growth, the economic downturn slows exports and growth. Following the devaluation, the economy goes into meltdown.
- 1998:** Thailand's devaluation has a knock-on effect across Asia and the "East Asian economic miracle" unwinds.
- 1998:** Asia's economic troubles and the ensuing slump in commodities prices, which hits countries reliant on exporting resources, prompts the Russian debt crisis.
- 1999:** Start of the Argentine economic crisis, eventually leading to the devaluation of the peso in 2002.
- 2001:** Goldman Sachs first uses the term "BRIC" to describe Brazil, Russia, India and China, which are seen as the next generation of economic superpowers.
- 2001:** China joins the World Trade Organization.
- 2001:** FTSE and Xinhua Financial Network announce the launch of the FTSE/Xinhua China 25 Index, a capped, tradable index

featuring the largest, most liquid Chinese equities available to international investors.

2004: Historic expansion of the European Union as the Baltic states of Estonia, Latvia and Lithuania and the Central European countries of the Czech Republic, Hungary, Poland, Slovakia and Slovenia, as well as Malta and Cyprus, all join.

2007: China's stock market hits a peak, having seen a three-fold increase in just three years.

2008: The price of oil peaks at \$147 a barrel on 11 July.

2008: Lehman Brothers files for bankruptcy on 15 September and there is a widespread sell-off in international stock markets.

2008: China reacts to the global slowdown by announcing a \$586 bn stimulus package to support economic growth.

2008/09: Historically low valuations lead to strong flows of external investment into emerging markets.

1.5 DECOUPLING AND GLOBALIZATION

Speak to any emerging markets fund manager and you will face a barrage of reasons to be optimistic about the outlook for the emerging markets but, to the less involved eye, some would seem to carry more weight than others. Arguably some of these arguments – for example, supportive demographics or improving standards of living – seem so intuitive one accepts them almost without question. With others, on the other hand – for example, the theory of “decoupling” or the idea of a commodities “supercycle” – one can find oneself thinking: “Well, OK – but, even if that's true, there are other arguments that are just intrinsically more convincing.”

That is the reason why Chapter 2 of this book weighs up the possible rewards – and associated risks – of potential growth drivers such as demographics, infrastructure and improving company processes under the heading of “The investment case for emerging markets” while decoupling and other less tried-and-tested ideas come under the microscope in Chapter 3, “New schools of thought – hype or reality?”

Decoupling really caught the imagination of professional investors in – note the timing – the first half of 2008. The theory ran that the emerging markets had evolved to such an extent they had “decoupled” from the rest of the world and thus the fate of their economies would no longer be determined by the fortunes of the US and Europe on the back

of, among other things, a reliance on the West as export markets. This time it would be different and when the West sneezed, the emerging markets would no longer run the risk of catching a cold. Ah.

“Our view is that you cannot have decoupling in a globalized world because, very simply, the world is a more integrated and interlinked place,” says Claire Simmonds, a portfolio manager for emerging markets at J.P. Morgan Asset Management. “A crisis that happens in the developed markets will impact emerging markets because of the linkages between capital flows, global trade and their greater integration with the world economy.”

At the broadest level, that view looks difficult to argue against although, as ever in these areas that provoke the most debate, perhaps it comes down to a question of degree. In other words, while global markets may not have decoupled, some emerging markets’ systems, institutions and structures have.

“In one sense decoupling is happening but in another sense not,” says Hugh Young, managing director of Aberdeen Asset Management Asia. “It is not happening in the sense that all the countries we look at – most obviously China, India and Russia – are far more part of the world today than they were 20 years ago. Barriers have come down rather than gone up and trade has moved across borders so, in that sense, there will be knock-on effects.

“What’s more, the global financial system will never decouple. The reason emerging markets went down in 2008 was because money was withdrawn by the West as they tried to de-risk their portfolios. On the other hand, for example, in terms of trade the US has become progressively less important.

“As for the nuts and bolts of the respective financial systems, the banks and regulators in the emerging markets were doing things very differently from the West and they generally didn’t get things wrong. Luckily for them they kept a very ‘plain vanilla’ financial system, which the West did not.

“So I would say there are different layers of complexities of coupling and decoupling because, yes, the emerging markets are very different from the West. In one sense, that now comes down to a more traditional sense of values, hard work, a desire to make it – in fact, arguably all the things that made the US great all those years ago – that is now present in these developing markets.”

For some commentators, decoupling is simply the wrong debate to be having. “The world is actually more complex than that,” says Jerome

Booth, head of research at Ashmore Investment Management. “I hate the ‘BRIC’ phrase but the one I hate most of all is ‘decoupling’. I find it ethnocentric and, fundamentally, a core-periphery concept.

“The base of the core-periphery concept is that the core affects the periphery but we ignore the effects vice versa – and that is a colonial attitude. It’s not a question of whether decoupling is a myth or not – it’s just the wrong model and you end up taking a very linear view of risk.

“The theory that all the countries are linked so that, if the US goes down, the emerging markets are worse off, is absolutely true but the conclusion you subconsciously draw from that is you therefore shouldn’t invest in emerging markets because it’s risky – and that is entirely the wrong conclusion.”

Booth’s thoughts about the relative prospects of developed and emerging markets in benign and worst-case economic scenarios are outlined in the next chapter, but he adds: “The right conclusion should be to accept that the relative performance of emerging markets will be substantially better in the worst-case scenario than even in the benign scenario.

“Therefore you should put money into emerging markets because it reduces risk in the worst-case scenario and yet the decoupling thesis precludes that thought process. It stops you thinking it because it is a core-periphery concept and, of its nature, one that prevents the impact of the periphery on the core being recognized.”

That seems a good place to leave decoupling – at least until we reach Chapter 3 – so instead let us carry on with the other side of the coin, the continuing integration of emerging markets into an increasingly globalized world.

“Globalization is all about transfers – the flow of money and goods and services,” says Chris Palmer, head of emerging markets at Gartmore. “How we react to globalization is where opportunities appear – just compare Argentina and Brazil.

“That comes down to each country’s reaction to globalization. Both have roughly similar levels of education, social development, resources and history and yet they have reacted completely differently. The future is not just emerging market versus developed economy but also emerging market versus emerging market and developed economy versus developed economy.”

In Titherington’s view, as soon as you accept globalization, the growth of the emerging markets from every perspective is inevitable. “And the globalization of the world is a phenomenon that is frankly impossible to reverse,” he says. “Once information has flowed, you can’t take it away

again and you shouldn't underestimate the importance of the Internet in that because one of the key elements of globalization is the flow of information.

"Globalization comes down to the basic opening of economies. Globalization doesn't happen in closed societies – North Korea, if you like, or Zimbabwe. Anywhere where a government can shut the society down, you won't see the impact of globalization but, over the last 10 years, the number of those societies has shrunk dramatically.

"I don't see that changing very much. You can make the comparison with history and, yes, there are people who argue globalization is just hype – that it was just part of the pre-credit crunch bubble – and that we've been through periods of globalization before that all ended in tears.

"But it usually ended with tears because there was a major war. Here the best comparison would be with the period before the First World War when people said Germany and Great Britain could never go to war because there was so much mutual trade and investment. But war is a very unusual event and, to say globalization is dead and consequently the emerging markets story is dead, you really do have to paint a pretty apocalyptic picture of war – a major war that shuts down trade and interaction between people and I don't see that on the horizon at all."

The rise of the G-20

The Group of Twenty (G-20) Finance Ministers and Central Bank Governors is an informal forum that was assembled to promote open and constructive discussion between industrial and emerging market countries on key issues related to global economic stability. The G-20 is made up of the finance ministers and central bank governors of the following 19 countries plus the European Union, which is represented by the rotating Council presidency and the European Central Bank. Members of the G-7 grouping of the world's richest nations are asterisked while the G-8 also includes Russia.

Argentina	Australia	Brazil	*Canada
China	*France	*Germany	India
Indonesia	*Italy	*Japan	Mexico
Russia	Saudi Arabia	South Africa	South Korea
Turkey	*UK	*US	EU

“The fact the reaction of the world’s governments to the global credit crisis went from being a G-7 response to a G-20 response rather tells you all you need to know about where the world is going,” says Titherington at J.P. Morgan Asset Management. “No fewer than 11 of the G-20 are emerging markets countries and it’s very important that, at a time of such crisis, nobody was talking about having a G-7 meeting. Even at a time when China is so obviously important, nobody was talking about a G-2 meeting either. It wasn’t Beijing and Washington sitting down to try and sort out the world – that wasn’t even on anybody’s agenda.”

1.6 AFTER THE STORM

As 2007 and 2008 brought the global credit crisis, mayhem in the financial sector and indiscriminate devaluations of stocks regardless of their actual strength or otherwise, emerging markets companies could have been forgiven for thinking they had travelled back in time to the previous decade.

Yet this time around, it was not Asian tigers, Latin American monetary policy or Russian borrowing that was at the heart of the problem. Instead, Western governments, companies and consumers had become overburdened with debt while the Western banking system was now paying the price for being all too complicit in allowing that situation to come about.

On the other hand, emerging markets governments, central banks and companies now appear to be substantially better equipped to ride out periods of economic and financial volatility precisely because of their chastening experiences in the 1990s.

The Asian financial crisis, to take one example, was caused, as the International Monetary Fund later put it, by “a combination of inadequate financial sector supervision, poor assessment and management of financial risk, and the maintenance of relatively fixed exchange rates”. More than a little of that sounds distinctly familiar.

As tends to happen, this encouraged banks and companies around the region to borrow large amounts of international capital but catastrophic devaluations followed when questions arose as to whether such debts could be repaid.

However, over the first decade of the new millennium and across the emerging markets, governments and central banks pursued more responsible and credible economic, monetary and regulatory policies while those companies that weathered the various storms moved to

restructure their balance sheets, pay back debt, improve their corporate governance and so emerged stronger.

All in good time, of course, to see the Western financial system go into meltdown itself although, from an emerging markets perspective, this was perhaps a case of it being an ill wind that blows no good – or at least further proof that what doesn't kill you makes you stronger.

“From a selfish point of view, it is good that the financial crisis happened because it is a test we needed the emerging space to pass,” says Slim Feriani, chief executive officer of Advance Emerging Capital. “All the cynics were saying emerging markets were a basket case and that, come the next crisis, they would all crumble.

“They argued they would be on their knees because they had seen that with the Tequila Crisis and the Asian Crisis and the Russian Crisis and so on. But the contagion effect stopped. We did have a contagion problem in the 1990s but what has happened since is the emerging market economies decided to clean up their acts and we can see the difference. So we had the Turkish Crisis at the start of the new millennium but that didn't really affect the rest of the emerging market space – and that's a big change.”

According to Urban Larson, director of emerging equities at F&C Investments, the experience of their various crises has also served to stand emerging markets investors in good stead. “It was interesting to watch the developed market investors panic as volatility hit the markets and how much calmer most of the emerging markets investors were,” he says.

“We're a lot more used to volatility. We've seen a lot of crises originating in emerging markets over the last 30 years although this is the first time we've seen a major crisis originate in the developed world – and it's been very satisfying that it's not our fault.

“What became clear from the crisis was that large parts of the imbalances were in developed rather than emerging markets and that, in general, emerging markets – with some key exceptions in Central and Eastern Europe – had underleveraged private sectors, underleveraged public sectors, solid fiscal positions, credible monetary policies and strong balance sheets.

“In other words, this was not the same kind of crisis for the emerging markets as it was for the developed world. It was a cyclical downturn and the advantage the emerging markets have in the recovery phase is they don't have to work off any excesses in order to resume growth. Yes, in some cases they need strong demand from developed markets but in

other cases it's a little simpler and really more a matter of getting the animal spirits moving again."

One crucial element in the post-financial crisis phase of the emerging markets story comes down to how their continued growth is to be funded. Not every emerging market is going to be playing on a level playing field, whether they would be hoping this funding is derived internally – for example, through consumer demand or reserves held in central banks – or externally from foreign investors. According to Khiem Do, head of Asian multi-asset at Baring Asset Management, the differences can be seen most starkly within the BRIC grouping.

"Their growth development paths haven't changed," he says. "All four economies still have a formidable growth path ahead of them in terms of industrialization, modernization and so forth. However, in the wake of the financial crisis, the obvious question is – if you all want to develop this and modernize that, how are you going to fund it? That's the key differential between the four BRIC countries.

"The shape of BRIC is now very different from a funding viewpoint and that obviously has been reflected in the currency, bond and stock market performance. These days a 10-year view gets reflected very quickly – and then it will change again – so you might say that these views only hold true in the short term. Maybe next year it will all be different.

"Even so, for now, the world has judged that Russia, despite its foreign exchange reserves, has over-evolved and overspent and overcommitted. So the question is whether the banking system around the world is going to be generous again to Russia – and to India – and just pour money in. Money will definitely come back but will it pour in? I doubt it."

Do argues it will take years for the big global banks to fix the damage done by the credit crisis and, while they do so, they are likely to become more domestically focused. "So, for example, the US banks will now say their main focus has to be on the US and anything outside is less important," he says. "This means, if they can obtain a good price for foreign investments, they may be more likely to sell up and concentrate on the US."

"If that theory is correct then, unfortunately, it won't be very encouraging for the potential borrowing trends of those countries and governments that need the money to fund their massive infrastructure and modernization programmes. Banks will not be thinking of profits but of how to safeguard the banking system in their own nation first, which is why it will be important to differentiate between those growth

economies that are in a position to fund themselves internally and those that are not.”

Do suggests the market will already have formed a view on which countries can and cannot do this and, while such a view may change in, say, the next five years or so, it is less likely to do so over the next one or two. “From our own analysis of the assets and liabilities of the four BRIC countries then, over the next two years, we believe China ranks number one by a long distance with Brazil in second place,” he says.

“India ranks number three and Russia number four. What’s more, Russia needs the oil price to stay solid but that introduces another factor into the equation. If you are reliant on something that is volatile, it becomes more complicated because there are many more potential outcomes.”

1.7 SO FAR, SO GOOD

In effect, the global financial crisis can be viewed as something of a “stress test” for the emerging markets and even some fund managers find themselves surprised how well they have acquitted themselves – thus far. “Yes, 2008 was the worst-ever year on an absolute basis for the emerging markets – down 54% in US dollar terms,” says Claire Simmonds.

“But if you put that on a relative basis, the emerging markets only underperformed by 12% to global equities over the year. That’s a much better outcome than if we look back to 1997 and 1998, where the asset class produced double-digit negative returns versus global equities that were up in the positive double-digits.

“So emerging markets have had their new combination of better macroeconomic fundamentals and improved micro-level performance stress-tested during this crisis – which, importantly, was a developed market crisis that originated in the US but impacted the emerging markets because we live in a globalized world. In our view, the sharp rally in 2009 was very much a reflection of the improved macroeconomics and also an acknowledgement that the financial system in the emerging markets is not broken.”

Going a step further, one might even argue the credit crunch was fundamentally good for the emerging markets because it forced the world’s central banks and policymakers to confront the issue of global monetary reform. Has the so-called Bretton Woods international financial system, which was agreed towards the end of the Second World War and

established, among other things, the International Monetary Fund and the World Bank, had its day?

“It is absolutely clear there has to be a move away from the defunct Bretton Woods system and that will involve a change in the reserve currency status of the dollar and the inclusion of emerging currencies in the basket of currencies deemed appropriate as reserves,” argues Booth. “We’re going to see an end to the recycling of capital and that inevitably will lead to much more retention of savings by emerging markets and the bulk of that is obviously going to go into real assets.

“Really there are two important adjustments countries will have to make. First, they have to absorb more capital – and that’s going to involve putting in place the right institutional and regulatory structures so they can have billions and billions going into infrastructure and real capital expenditure – and, second, they need to get the financial markets to help do that, which means building local bond markets.

“What the credit crunch has done is speed up the development of this process. The credit crunch is a very positive force because it has changed more rapidly the need for people to rethink what the global economy looks like, how to invest in terms of asset allocation and what risk is.”

What the credit crunch has already done, says Booth, is to show the emerging markets’ system worked – at least with regard to the reserves of currency held by central banks and monetary authorities to back their liabilities. “The emerging markets now know the right levels of reserves they need and that they now have enough,” he says.

“They’re probably not going to reduce them that much but they don’t have to have more either. That naturally means that when the dollars start coming in they won’t immediately build up reserves. They will move towards some kind of current account deficit – or current account balance certainly – and they won’t allow further big surpluses. They will allow their currencies to appreciate and focus on domestic demand. Ultimately, emerging markets are going to invest across each other rather than in the dollar.”

1.8 INTERACTION BETWEEN EMERGING MARKETS

The fact that emerging markets have been seeing a change in the make-up of who they do business with is another important development. While they have undoubtedly been shaken by the recessions in the US and Western Europe, many emerging markets are losing their traditional

reliance on developed economies. This growth in trade between fellow emerging markets has helped them weather the economic storm that followed the credit crisis.

Leaving aside any arguments on the existence or otherwise of decoupling, what this really boils down to is the degree to which the emerging markets can insulate themselves from any slowdown in the US economy. Two elements that suggest they can are favourable demographics – for example, young and increasingly wealthy populations generating a boom in domestic consumption – while, crucially, export destinations have greatly diversified so there is no longer such a reliance on the West.

Instead, there has been a dramatic jump in trade between emerging markets so that, to focus on just one example, in May 2009, Brazil's Ministry of Development, Industry and Exterior Trade published statistics that showed China had replaced the US as the country's biggest trading partner, thereby interrupting a relationship that dated as far back as the 1930s.

Indeed, in one sense, the future of emerging markets is all going to come down to relationships – how the developed world interacts with emerging markets, how emerging markets interact with each other and how the smaller economies interact with the giant BRIC economies in each region.

“All the smaller countries in the emerging markets have got to define their relationships with the big four – and out of that you're seeing some pretty clear winners and losers,” says Titherington. “For example, Argentina is a loser because it is becoming irrelevant as Brazil is increasingly dominating the whole of South America. Argentina is just flapping in the wind now, wondering what to do. In fact, everybody else is really struggling to have any relevance there – it's why Hugo Chavez is making such a fuss in Venezuela, because he wants to be relevant in some way.

“By the same token – and principally because of the impacts of the Asian crisis on the world – Asia is increasingly dominated by China. All the other countries – South Korea, Taiwan, the Philippines, Thailand and so on – are going to have to work out what they do about that.

“The whole point about the next five years is it is going to be a harder environment with less access to capital and less natural investor enthusiasm and so people, countries and companies are all going to have to work harder to attract attention – and the risk is that the BRIC countries will dominate all the attention.”

Perhaps the relationship that is causing the most global interest – although in some quarters “concern” might be a better word – is that between the BRIC economies, most particularly China, and the continent of Africa. “China is building up control of the natural resources,” says Bob Yerbury, chief investment officer of Invesco Perpetual. “There are the obvious natural resources but there are also the more obscure metals that the Chinese will control production of. There is a great danger of Western economies waking up in 10 years’ time and it being too late.”

More fool them, the Africans, the Chinese and their other BRIC counterparts would presumably reply. Be that as it may, it is the BRIC countries and not the developed economies that are redefining Africa’s role in the global economy, driven by a clear-eyed combination of “solid commercial needs and common interest,” according to Simon Freemantle and Jeremy Stevens, economists at Standard Bank and co-authors of the paper *BRIC and Africa: tectonic shifts in BRIC and Africa’s economic destinies*.

Having worked out more than a decade ago that Africa would play a crucial role in its own development, China has led the continent’s economic transformation and the relationship has grown to such a degree that, by 2008, Africa was receiving 30% of China’s entire bilateral aid budget.

China’s President Hu Jintao has made official visits to Africa every year since 2003 while, in November 2009, premier Wen Jiabao pledged \$10 bn in new low-cost loans to Africa over the following three years – in passing taking the opportunity to reject accusations the country was “plundering” the continent’s oil and minerals.

“The main reason Africa has not participated on the global economic stage until recently is an almost complete lack of infrastructure,” says Titherington. “At the most basic level, the crops rot in the field if you can’t transport them to a port and onto a boat.

“The lack of infrastructure might be down to corruption or political instability or plenty of other reasons but, without it, no country is going to progress. It is interesting therefore that the biggest investor in Africa is China and what they are concentrating on is building infrastructure. In the near term, if the Chinese decide to stop building infrastructure in Africa because they need to concentrate on building it at home, then that would be a big negative.”

Perhaps the biggest obstacle to China quitting Africa is that the commercial and diplomatic benefits are increasingly mutual. “China’s interest in Africa is far from cyclical,” say Freemantle and Stevens. “If

anything, the speed of China's engagement with Africa since the turn of the century underlines that China relies on Africa as much as Africa relies on China."

Turning to the other BRIC countries, Freemantle and Stevens say Russia's involvement in Africa appears to be geopolitically motivated and, as a result, its activity has been focused on the energy sector – specifically oil, gas and uranium. "By 2009, Russia was supplying 20% of Europe's natural gas and moves to secure additional supplies destined for Europe in Libya, Algeria and Nigeria suggest its ultimate intention may well be to increase its bargaining power with the West," they explain. "In an interesting extension of this theme, Russia was reported to have been showing interest in securing uranium supplies from Namibia, now the world's fourth largest producer."

India's interest in Africa is more blatantly commercial. "While total BRIC-Africa trade in 2008 amounted to \$157 bn, India has set an objective to bring its own individual trade with Africa up to \$70 bn by 2013," say Freemantle and Stevens. "Although one of India's key priorities has been to diversify its oil supplies away from the Middle East, Africa-India trade covers a broad range of technological and manufactured products, facilitated by Africa's sizeable population of Indian origin."

Of the BRIC quartet, Brazil's involvement in Africa is perhaps the least well recognized but it has been growing steadily – partly down to strong linguistic and cultural links with Angola and Mozambique, courtesy of their earlier joint ties with Portugal, and the fact that more than 45% of Brazilians claim direct African descent.

"Brazil's activity in Africa has been highly focused on the energy sector, in particular bio-fuels, in which it has particular expertise," say Freemantle and Stevens. "More than 75% of all new Brazilian cars run on a mixture of petrol and bio-fuels." Brazil's other energy-oriented interests on the continent include offshore oil-drilling projects in Angola and Nigeria and mining operations in Mozambique.

According to research from Standard Bank, Africa is both a large and fast-growing consumer market and a vital source of growth and this has enabled BRIC-African trade to increase from \$16 bn in 2000 to \$157 bn in 2008 – a compound annual growth rate of 33%. "This is no mere 'flash in the pan'," say Freemantle and Stevens. "Given the BRIC economies are the fastest growing in the world and, on a medium-term view, are likely to equal the importance of the world's developed economies, Africa is positioned to play a pivotal role in that development for the foreseeable future."

1.9 THE ETHICAL DIMENSION

Since we have just raised a metaphorical eyebrow concerning the motives behind China and Russia investing so heavily in Africa, this would seem as good a point as any to flag up an issue that tends not to receive a huge amount of coverage – the ethics or morality of investing in emerging markets.

Ethics and investing in general have always had a strange relationship – hence the growth of a whole subsector of socially responsible investment, which at one end of the spectrum avoids investing in companies linked to, for example, arms manufacturing, gambling, pornography and alcohol and tobacco products and at the other seeks to encourage better corporate behaviour, particularly with regard to the environment and employee welfare.

A survey of financial services consumers carried out by the UK-based Ethical Investment Research Service towards the end of 2009 identified a shift away from worrying about what might be termed “sin issues” – alcohol, gambling and so forth – towards a greater focus on more contemporary ethical concerns, such as the environment, human rights and fair trade.

Indeed, in terms of the issues consumers wanted banks and other financial institutions to prioritize, the one considered the most pressing of all was protecting human rights, which arguably also has the most resonance in the context of the emerging markets.

Certainly, one of the dangers in writing this book has been typing an idea that, while perfectly sound from an investment perspective, does not read back so easily in more human terms. By the same token, some of our experts have occasionally tied themselves in knots in an attempt not to sound too callous – and it is not entirely coincidental that it tended to be on the subject of China and democracy.

“Obviously China is not democratic but, because it is not democratic, it can push through unpopular structural reforms much more quickly than in other systems,” began one. “So that’s an advantage and a disadvantage. There are a lot of cases where you would wish to have more transparency and a fairer treatment of people in general – there’s no doubt about that – but in terms of speed and execution of restructuring the economy, the existing system is the one that can enable it the fastest.”

Even more bluntly, on the difference in the development paths between China and India, another expert said: “So far, most rational analyses would say that the relative lack of democracy in China has been to

its benefit. In other words, it's growing faster because it hasn't had, dare I say, the 'impediment' of elections and democracy and it's been able to build out its infrastructure very much faster and at a more efficient rate because people just do things – however distasteful that may be to Western ears.”

In both instances – as with the observation of yet another of our experts that “No country ever got wealthy through free trade” – it is hard to argue with the theory although such statements do lack a little in the compassion department. On the other hand, as already suggested – much as one may wish it otherwise and the socially responsible aspect apart – investment and compassion don't always make for easy bedfellows.

Perhaps this is most starkly illustrated by the actions of foreign investors in China after the brutal suppression of the student-led pro-democracy demonstrations in Tiananmen Square in 1989. Levels of foreign direct investment into China may have stuttered for a while but by 1992 it was up to \$11 bn and in the latter half of the 1990s stayed consistently between \$40 bn and \$45 bn a year. In the world of investment, to misquote the old saying, you makes your choice and you pays your money.

As a final note on this subject, we acknowledge that increased consumption – one of the pivotal arguments in favour of investing in emerging markets on the back of continually improving living standards and the development of aspirational middle classes running into the hundreds of millions – does not sit too easily with the prevailing mood of austerity, environmentalism and sustainability in parts of the developed world.

We offer no view on this beyond saying it will be an interesting match-up between the environmental lobby and the millions of newly middle-class consumers in, for example, China and India being told they should not enjoy the white goods, the air travel and the all-round standard of living the developed nations have taken for granted for decades.

1.10 CONCLUSION

So will it be different this time for the emerging markets? To avoid having to dare to contradict one of the greats of investment, perhaps we might simply say emerging markets have the opportunity for that to be the case. That opportunity has come about partly thanks to the emerging markets' own positive actions in the wake of the catalogue of

economic crises suffered in the past and partly from the damage done to the Western financial system – both reputationally and arithmetically – by a crisis that was very much of the West’s own making.

The credibility gap has narrowed and the playing field has been levelled and that is before we even come onto all the reasons for considering investing in emerging markets that are outlined in the next chapter alongside, yes, the reasons why one should also tread carefully.

“There are always going to be concerns with rapid growth,” says Yerbury. “Go back to October 2007 when the Western banking system started falling apart and at no point did we feel we should be cutting our emerging market exposure. There was no argument about it being risky or speculative – we saw it as a genuine long-term opportunity and believed we should stick with it.”

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