Investment insight

Seen this movie before? Emerging markets again in the spotlight

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Emerging markets are again under pressure as investors ponder a world without quantitative easing

Over the past year or so I have written a lot about the impact of quantitative easing on financial asset prices across the world. In a nutshell, the extraordinary measures that the major central banks – particularly the US Federal Reserve (The Fed) – have taken to boost economic growth have tended to distort asset prices in a range of markets.

Short-term interest rates at or close to zero, and government bond yields at multi-decade or in some cases multi-century lows, have encouraged investors to seek out higher returns in higher risk investments, including shares and non-government securities.

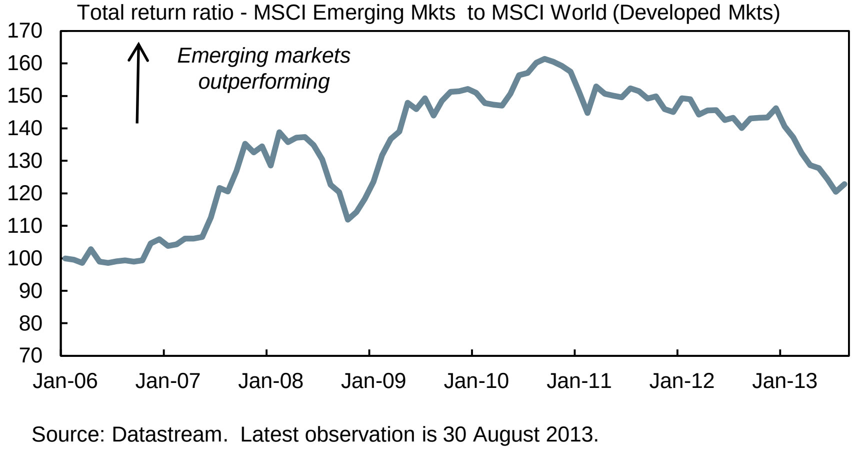
One early beneficiary of the search for higher returns was the emerging markets. Emerging economies including India, Brazil, Indonesia and Turkey have attracted enormous inflows of private capital in recent years and experienced rapid rates of economic growth and massive share price gains. The strength of those capital inflows has been associated with wider current account deficits and rising levels of debt.

So far this year, share prices in the emerging markets have fallen by around 5%, a particularly poor result given that the developed markets have managed to post share price gains of around 13%.

Emerging markets have underperformed for some time

Chart 1 shows the ratio of emerging to developed market equity returns. Emerging share markets have underperformed developed markets since August 2010, despite continued strong inflows of private capital over much of that period. The trend of underperformance in the emerging markets has clearly accelerated in 2013.

Chart 1: The underperformance of emerging markets equities has accelerated in 2013



Source: Datastream. Latest observation is 30 August 2013.

Emerging markets again in the spotlight

How have emerging share markets performed in 2013?

If we look at the worst performing emerging share markets this year, shown in Chart 2, several of them are the erstwhile darlings of international investors.

The decline in Chinese share prices reflects the slowdown in Chinese growth that has been evident for some time, and the uncertainty about China's ability to sustain what remain very rapid rates of growth. Not surprisingly, these concerns have also undermined sentiment in a number of commodity dependent emerging economies, including Brazil, Chile and South Africa.

Over the course of 2013, not only have share prices declined in the emerging markets, but emerging currencies have depreciated against the US dollar, yields on emerging market sovereign bonds have risen, and spreads over US Treasury bonds have widened considerably.

The damage has occurred in the wake of the Fed's signals that they are likely to begin unwinding some of the massive monetary policy stimulus – 'tapering' the amount of quantitative easing they undertake – sooner than previously thought.

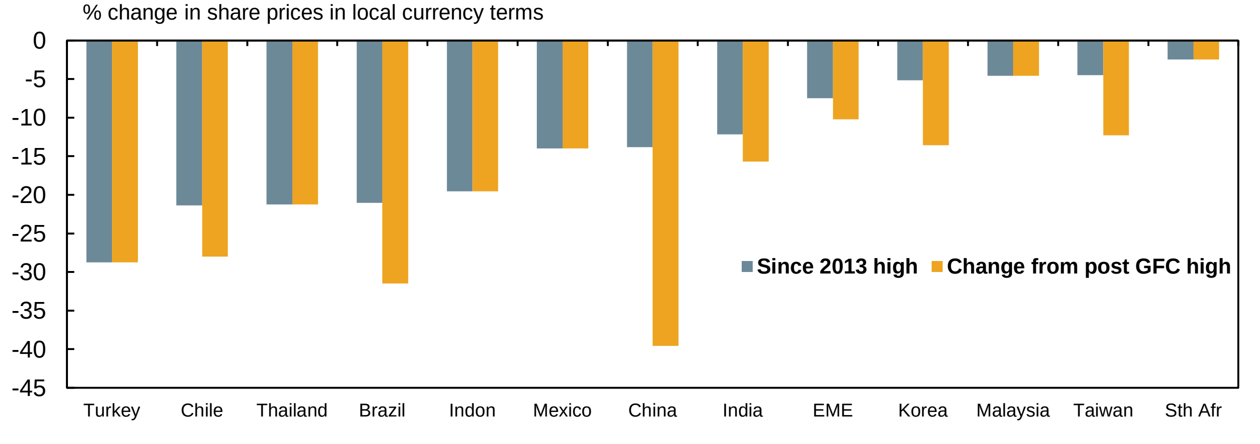
The Fed's signalling has seen US Treasury yields move sharply higher this year. Flows out of US financial assets into key emerging economies appears to have weakened considerably, and markets are concerned about the ability of a number of emerging economies (including Indonesia, India, Turkey, and Brazil) to continue funding substantial current account deficits in this environment.

Is another emerging markets crisis looming?

The weakness seen in emerging share markets and currencies has raised fears of a renewed crisis in the emerging economies. Previous episodes where foreign investors have withdrawn capital en masse have often ended badly, particularly when policymakers are faced with the choice of tolerating weaker currencies and higher inflation, or raising interest rates in a bid to either defend their currencies or control inflation or both.

The 1997 Asian financial crisis is a case in point. In the years that preceded the crisis capital inflows, particularly in the form of US dollar denominated borrowings, boosted growth across much of the region. However, when capital flows began to reverse and currencies declined, efforts by the authorities in countries such as Thailand, Indonesia and Korea to arrest the slide in their currencies forced interest rates sharply higher and caused a severe recession.

Chart 2: Emerging market shares' disappointing performance in 2013



Source: Datastream. Data as at 30 August 2013.

Emerging markets again in the spotlight

So far, the weakness seen in emerging markets has tended to be far more orderly than in previous crisis episodes. Moreover, markets have tended to be discerning this year: markets such as Korea and Taiwan, for example, have fared relatively well, and do not appear to face the same vulnerabilities as other emerging economies.

This time could be different

There are a number of reasons to believe that the emerging world will fare much better this time round, and will likely weather an eventual tightening in US monetary policy.

Many of these economies are today better managed and better governed that previously, foreign exchange reserves are higher, fiscal positions are generally stronger, and the quality of the underlying businesses listed on emerging market exchanges is considerably better.

However, in a globalised world, many of the companies we invest in obtain at least part of their revenue from the emerging markets. Indeed, the companies in our global share strategy derive around 25% of their revenue from emerging markets.

However, the dependence of a number of key emerging economies on foreign capital for their growth has again made them vulnerable. While policymakers are not in panic mode, official interest rates have nevertheless been raised in a number of countries in recent months – including Brazil, Turkey, and Indonesia – suggesting that central banks are not willing to tolerate the inflationary impact of weaker currencies.

What is our exposure to emerging markets?

At MLC, the well-diversified nature of our portfolios means our direct exposure to emerging share and bond markets is relatively modest. Our exposure to emerging markets in our global shares strategy, at less than 10%, is below benchmark weight and has been for the past year.

Within our bond strategies, our emerging market exposure is minimal, but a number of our managers can and do invest in emerging markets debt and currencies from time to time.

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Given their growing importance in the world economy, exposure to emerging markets makes a good deal of sense as part of a well-diversified investment strategy, despite their vulnerability to periodic crises. According to the International Monetary Fund, emerging and developing economies now account for nearly 40% of global GDP – a figure which has nearly doubled since the last major emerging markets crisis in 1998.

However, the concerns surrounding the emerging economies at present highlight just how uncertain the world remains for investors, and just how vulnerable markets might be in the event that central bank support in the form of quantitative easing eventually ends.