

June 2009

## Will emerging markets lead the global recovery?

# INSIGHTS



**While emerging markets have been impacted by the global economic downturn, in our view their strong fundamentals in comparison to more developed markets means they are well positioned to benefit from long-term growth.**

Emerging markets have deservedly become a key component of international share portfolios, as their underlying economies have gained in fundamental strength. Having learned their lessons from the 1990s, emerging countries have enhanced their legal, regulatory and governance frameworks and have become more fiscally disciplined.

In 2008 emerging markets experienced a sharp pullback, with the MSCI Emerging Markets Index declining 51% after surging by 400% in the preceding five years in Australian Dollar terms.

While the first two months of 2009 continued the downward slide, the Index recovered by 1.3% in the March 2009 quarter, outperforming the MSCI World ex-Australia Index which fell by 11.9% over that period. In April, emerging markets outperformed with a 10.4% return compared to 5.2%, although performance varied across regions. The disparity in regional performance reflects the differences in fundamentals across the regions and technical factors – both discussed below.

### Technical factors

In 2008, the sell-off in developed markets was driven by factors of a fundamental nature such as poor quality financial assets and excessive debt. This wasn't entirely the case with emerging markets. In addition to concerns about the global economy, trade and exports, emerging markets were impacted by repatriation of funds and liquidations by hedge funds. The resulting outflows in 2008 are estimated at \$70 billion.

This trend is beginning to reverse, with inflows amounting to \$10 billion year-to-date. Sentiment has improved as investors are discounting the probability of a meltdown in the global financial system, re-focusing on growth opportunities and beginning to pay regard to fundamentals in emerging markets. This led to contraction in the risk premium in emerging markets and reduced the selling pressure on stocks in the region.

### Fundamental/ economic factors

Emerging economies as a group now have credible economic fundamentals. Although growth in their GDP and in industrial production fell in absolute terms, they have retained positive margins on both of these measures over the developed economies. In our view, China is one of few countries in the world which should deliver positive economic growth this year.

The developed world suffers from high debt, over-consumption and from poor quality financial assets. The emerging world is not immune to global problems but its low debt, high savings and lower exposure to affected assets, and conservative financial and banking practices, have limited the damage to its financial system. This should enable an easier recovery process, particularly in Asia and Latin America. Eastern Europe has been slower to evolve, and has sustained greater damage.

Emerging economies have savings rates of in excess of 20%<sup>1</sup>. Savings are particularly high in Asia, as Singapore, Malaysia and China save 40% to 50% of their income. By comparison, savings in the US and UK stand at 12% to 14% of income. Many emerging economies have established sovereign wealth funds, for example the Government Investment Corporation (\$330 billion) and Temasek Holdings (\$159.2 billion) in Singapore; China Investment Corporation (\$200 billion); and the Stabilisation Fund of the Russian Federation (\$158 billion). Naturally, many emerging economies are now net creditors to the developed world.

A Credit Suisse<sup>2</sup> study of financial and economic resilience of 34 countries concluded that emerging economies as a group are now at least as fit to weather tough times as their developed counterparts. The US and UK received the 13<sup>th</sup> poorest and the 7<sup>th</sup> poorest scores out of the 34, respectively. Asian countries ranked best as a group. China scored the strongest, followed by Singapore, Philippines and Hong Kong. Smaller nations in emerging Europe received eight out of the bottom 10 scores, while Latin America ended up with middle-level scores.

### Currencies

Historically, currency instability was one of the key risks for investors in emerging markets, particularly during periods of global (and domestic) economic downturns. This risk still exists and the underlying currencies remain volatile, however much less so now.

<sup>1</sup> UBS Emerging markets Navigator, December 2008

<sup>2</sup> CS scored countries on a combination of ratios of current account, government debt, public sector debt, external assets, external debt and commodity exports relative to GDP, bank loans-to-deposits ratio and CDS spreads. Sponsored by Fullerton.

Our research shows during the current crisis, some currencies have depreciated by 30% to 40%, with Eastern Europe and Latin America having been hit the hardest. These falls were large but much smaller than the 80%+ losses recorded by some of the emerging currencies in the 1990s, as governments and multi-national institutions have taken measures to avoid currency-led crises. China, Russia, India and Brazil now hold US\$1,953 billion, US\$385 billion, US\$256 billion and US\$205 billion in foreign currency reserves, respectively.

Asian countries have established a system of bi-lateral currency swaps under the Chiang Mai Initiative and in February 2009 agreed to establish a foreign currency fund to enable nations to borrow foreign currency on a short-term basis. Finally, the International Monetary Fund (IMF) provides emergency financing to countries with severe economic difficulties subject to certain requirements<sup>3</sup>, thus reducing pressure on their currencies. Some of the recent beneficiaries have been Hungary, Poland, Mexico and Columbia.

### Stimulus

Similarly to developed nations, many emerging countries have embarked on economic stimulus measures to counteract the effects of the global financial crisis.

China's US\$585 billion fiscal stimulus package and its pro-lending policies have assisted stabilisation in its property sector, led to increases in its fixed asset investment, and lent support to its industrial production and in retail sales according to AMP Capital research. In fact, talk of a hard landing (defined as 6% or less annual growth in China) is now giving way to hopes that GDP growth this year will be around the 8% level. However, China's exports fell by 22.6% year on year. As the world is in recession, China's economy relies on government support but the size of its reserves and its fiscal position, along with its healthy financial system, suggest that its government can afford to sustain the stimulus for some time.

China's stability and growth in its fixed and infrastructure investment are benefiting the rest of the emerging economies. However, China is not the sole driver of their economic recovery. Many of these economies have ample means to stimulate their domestic growth, and have introduced fiscal and monetary stimulus programmes. For example, Russia is spending US\$17.6 billion in welfare programmes, tax cuts, and industry subsidies, and provides guarantees for commercial

banks. South Korea's supplementary budget of US\$20.8 billion provides for US\$12.9 billion in fiscal expenditure to create jobs and to support exporters. Brazil announced an increase in minimum wages and new welfare programmes. Finally, emerging economies are beneficiaries of the stimulus efforts made by developed economies, and will be the key beneficiaries of any recovery in the global economy.

### Investment outlook for emerging markets

We would not extrapolate the level of gains that emerging markets have delivered in the past couple of months into the near future, for the following reasons. The recent rally has reduced the discount of emerging markets relative to the world. Corporate earnings will remain under pressure as global economic activity continues to contract and further volatility is likely to emerge should the recession in major world economies become more protracted than the market currently expects.

Emerging markets will be impacted by volatile exchange rates and commodity prices, magnified by market sentiment and swings in risk appetite. Given the thus-far tentative nature of the first signs of market and economic stabilisation globally, these swings may remain substantial for quite some time.

Taking a longer-term perspective, emerging markets will be the key driver of global growth as they possess important structural advantages, including rapid urbanisation, significant spending on infrastructure and healthy demographics. A number of constituents, including Russia, South Africa, the OPEC countries and Brazil are major exporters of energy and commodities that are needed by developed and developing economies alike. Importantly, from a longer-term valuation perspective, emerging markets are close to their historic lows as measured by market capitalisation to GDP ratio.

The disparity in performance by regions and countries within emerging markets will persist, driven by differences in their fundamentals and sources of growth and, of course, the future path of the global economy.

### Gaining exposure to emerging markets

The Future Directions Emerging Markets Shares Fund and Future Directions Asia Ex-Japan Shares Fund provide investors with access to global emerging markets and to the Asia ex-Japan region, respectively. AMP Capital has also recently launched the AMP Capital Asian Equities Growth Fund, targeting investment opportunities across Asia. For more information, visit [www.ampcapital.com.au](http://www.ampcapital.com.au)

<sup>3</sup> IMF would provide financing to countries with a good track record in terms of microeconomic discipline and adequate policy frameworks

## Contact us

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