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Emerging Markets Face Stiff Headwinds

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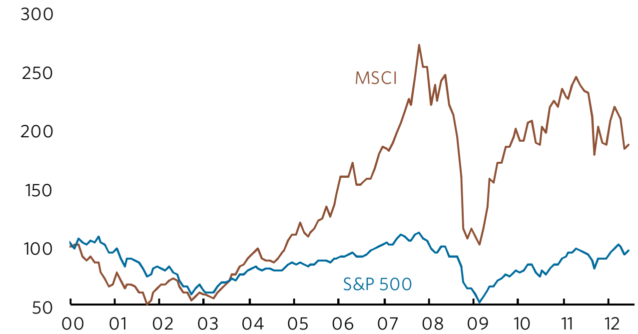
Analysts and investors are becoming increasingly concerned about the near-term prospects for emerging market (EM) economies as evidence of marked EM economic deceleration mounts. Furthermore, there is widespread recognition that the continued festering of European problems threatens to cause a sharp decline in world trade and a reversal in capital flows, two critical issues for most EM economies. Yet, there is another aspect of the EM situation that is not on most observers' radar screens: EM economies face not just a cyclical problem but also a difficult structural transition during unusually challenging times. Consensus expectations for EM economies remain too optimistic, and investment returns on EM assets are likely to be disappointing and volatile over the next several years.

In 2008, just as EM exports to the developed world had reached a scale where continued rapid growth was becoming increasingly difficult (most notably in the case of China), the trend was abruptly broken by the severe recession, and since then the contained depression in the developed world has continued to constrain EM exports and exert a persistent downward pressure on EM current account balances. Meanwhile, developed world banking sector retrenchment—especially in Europe—has led to what will likely prove to be a decline in foreign financing flows to EMs lasting many years. The transition to greater reliance on domestic profit sources and domestic credit growth is already proving difficult, and the potential for banking problems is increasing.

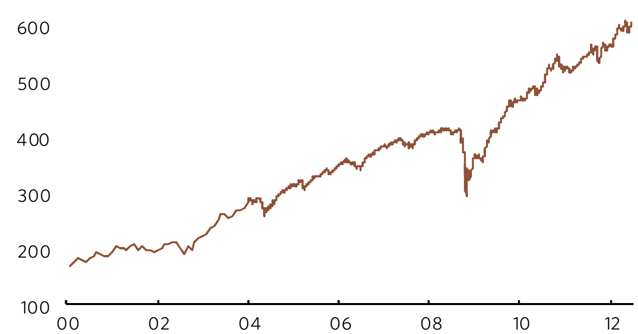
Great EM Performance in the 2000s CHART 1

Stock Market Indexes: MSCI Emerging Markets, S&P 500
re-indexed Jan 2000=100, end-of-month, last data point June 22, 2012



High Investor Returns/Cheaper EM Funding CHART 2

JP Morgan Emerging Market Bond Total Return Index
mid price, end-of-month to 2003, then daily close; last data point June 22, 2012



The 2000s: A Golden Decade for EM Investors

Investors in a wide variety of EM assets were richly rewarded in the 2000s. The broad EM equity index, denominated in dollar terms, doubled from 2000 to 2010 (chart 1). The performance of EM bonds was even better (chart 2) thanks to (1) the absence of major EM crises, (2) the steady decline in spreads as credit quality and credit ratings improved, and (3) the secular decline in global benchmark interest rates. Most EMs also experienced significant currency appreciation, which enhanced investment returns for advanced country investors.

The spectacular performance of EM investments for most of the 2000s was underpinned by robust fundamentals. Red hot economic growth was sustained through much of the decade, in stark contrast to the anemic growth in the advanced countries and to the EM experience in the previous decades (chart 3). Moreover, unlike the 1980s and 1990s, which were characterized by financial instability engendered by periodic EM foreign exchange crises, the 2000s were relatively tranquil financially for EMs until 2008. The war chest of foreign exchange reserves that EMs had accumulated after the Asian and Russian crises—

and continued to accumulate thereafter—greatly reduced the likelihood of another systemic EM currency crisis.

The stellar EM economic performance was supported not only by improvement in internal structural factors but also, importantly, by developments in the advanced economies. The burgeoning current account deficits in the advanced world greatly boosted EM profits. Advanced country current account deficits at their widest may have accounted for close to 30% of profits in EMs. Surging exports also fueled EM investment geared toward meeting export demand, further boosting profits.

Also, the swelling of private balance sheets, especially bank balance sheets, in much of the advanced world and the hunt for returns amid falling yields stoked powerful growth in all kinds of capital flows into EMs. These inflows led to a steep plunge in borrowing costs and buoyed asset prices. In turn, asset price gains further boosted domestic fixed investment, buoying profits.

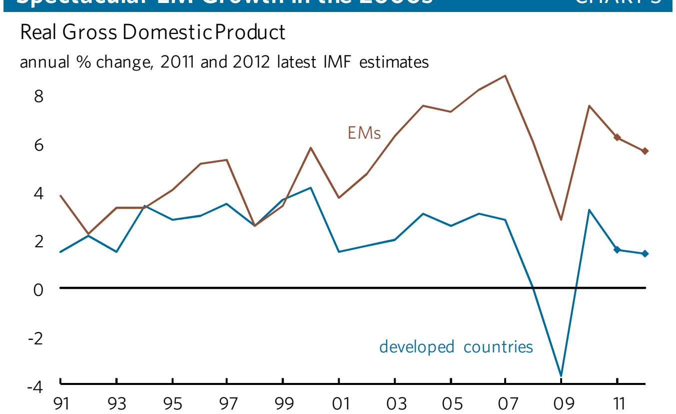
EMs' New Reality

However, the sea change in the advanced economies since 2008 is having profound ramifications for the EMs. The contained depression in the United States and Europe is contributing to a secular improvement in their non-petroleum trade balances and a concomitant worsening of current account balances in most EMs (chart 4). The changing trade picture represents a major blow to profits both directly through the worsening of current account balances (i.e., an increase in foreign saving in the profits equation) and indirectly through sharp declines in investment in export industries.

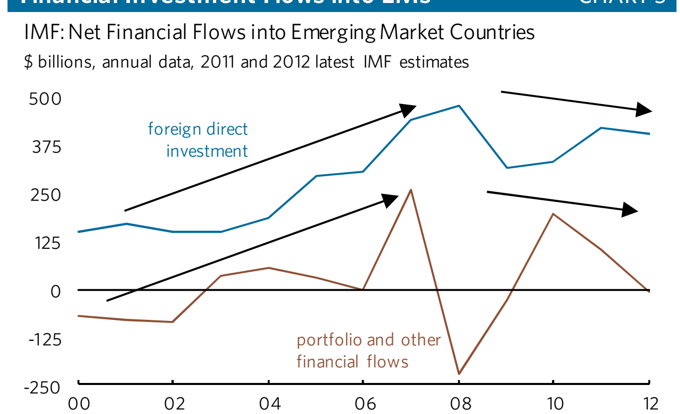
Moreover, the contained depression is fostering a secular move toward greater risk aversion in the advanced economies, as we have argued. This development is dampening international capital flows into EMs (chart 5). In particular, retrenchment by bloated and beleaguered European banks (chart 6) is steadily shrinking the financing avenues for EMs and raising financing costs. European bank retrenchment is still in its early stages, and capital flows from advanced economies will be hampered for several years.

Since 2008 EMs have been attempting to counteract the decline in foreign profit sources by boosting domestic profit sources, and they have been trying to compensate for receding foreign capital by spurring domestic bank credit. The widening of government deficits in many EMs and the explosive growth of domestic lending, aimed at stimulating domestic investment

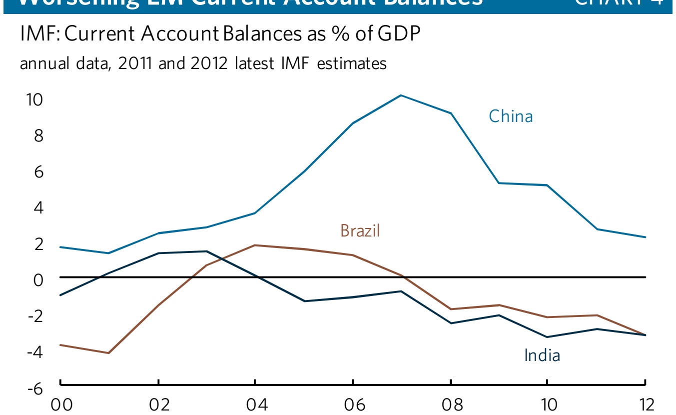
Spectacular EM Growth in the 2000s CHART 3



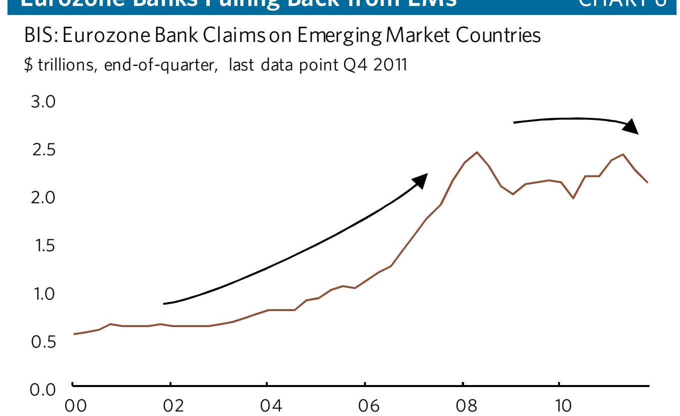
Financial Investment Flows into EMs CHART 5



Worsening EM Current Account Balances CHART 4



Eurozone Banks Pulling Back from EMs CHART 6



and consumer spending, are testament to the need to generate profits from domestic sources.

Thanks to aggressive policy measures, EMs rebounded rapidly from the 2008-2009 crisis, in contrast to advanced economies. However, it is already becoming apparent that managing the transition to an economy driven primarily by domestic profit sources and home-grown credit poses many challenges.

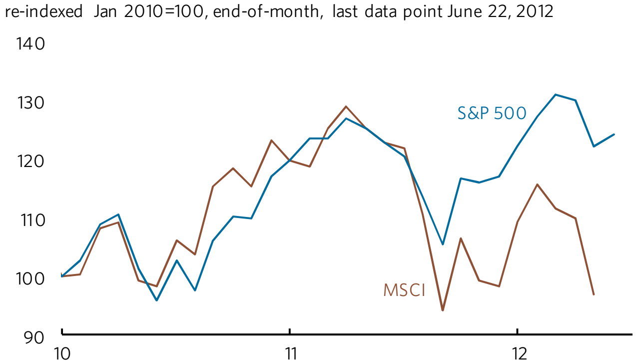
- Many EMs have rudimentary financial systems and are incapable of supporting robust domestic credit creation. For example, most central and eastern European countries are heavily dependent on western European banks and their subsidiaries, and they are experiencing credit contraction as euro area banks retrench.
- Even in countries with more developed banking systems and better ability to generate credit domestically, the process can be fraught with pitfalls. Rapid credit growth, even when credit is small relative to GDP, can overwhelm the capacity of financial institutions to screen and process loans and result in bad lending decisions and financial stress. Brazil, for example, has a relatively low credit-to-GDP ratio and is in the midst of a secular credit boom. Nonetheless, it is experiencing a surge in nonperforming loans and is not immune to moderate-to-severe credit cycles within the secular expansion.
- In many EMs, the credit-to-GDP ratio is not as low as it was a decade ago, and further rapid credit expansion will increase the potential for financial instability. In China, the credit-to-GDP ratio was already approaching developed country levels in 2008, and policymaker attempts to propel domestic demand via an explosive growth in credit inflated a real estate bubble. Chinese policymakers are now grappling with the consequences of the deflation of that bubble.
- EM policymakers who pursue a growth strategy based on domestic demand may struggle with finding the balance between controlling inflation and maintaining growth. Policymaker efforts to control a wage-price spiral by tightening monetary policy will necessarily adversely affect domestic credit creation and private profit source generation. Note India's struggles to curb inflation without squelching growth.

Since 2010 EM equities have lagged the S&P 500 (chart 7), EM bond spreads have remained elevated, and many EM currencies have suffered sharp depreciation (chart 8). Yet many analysts are operating under the implicit assumption that the economic environment facing EMs has not changed much from the last decade. They suggest that shifting the emphasis from the "X" to the "C" in the GDP equation is not all that difficult.

To be sure, most EMs are financially much stronger than they were 15 years ago. They have, on balance, much greater foreign currency reserves and are not facing a re-run of the currency crises of the 1980s and 1990s. Nevertheless, economic growth is likely to be much weaker and financial conditions more volatile than widely anticipated. Over the next several years, EM investments on the whole (allowing for wide variations from country to country) will in all probability return far less than consensus expectations.

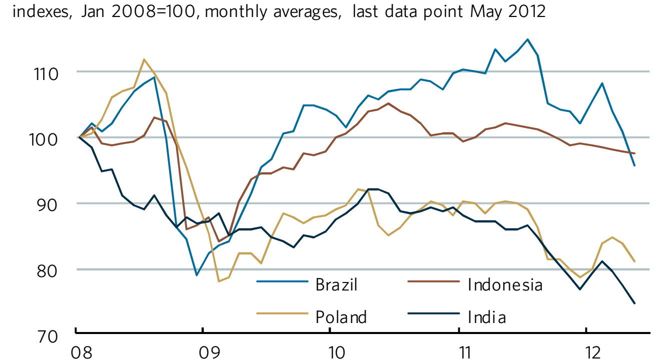
EM Equities Underperforming Since 2010 CHART 7

Stock Market Indexes: MSCI Emerging Markets, S&P 500
re-indexed Jan 2010=100, end-of-month, last data point June 22, 2012



EM Currencies Failing to Appreciate CHART 8

JP Morgan Broad Nominal Effective Exchange Rates
indexes, Jan 2008=100, monthly averages, last data point May 2012



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