



Why Emerging Markets Still Make Attractive Investments

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Up until a few months ago, inflation was something mainly central banks in the developed world concerned themselves with. As Mervyn King and Ben Bernanke struggled to decide which was the lesser of the two evils – slowing economic growth or inflation – emerging markets (EM) looked like they were about to come out of the credit crunch relatively unscathed. However, fast-forward to July 2008 and inflation has become the biggest threat facing EM, driven in large part by skyrocketing food and energy prices. According to the Asian Development Bank, inflation in the Asian region is expected to reach a decade-high this year and is accelerating faster than anywhere else in the world. Inflation now exceeds targets in at least 19 emerging economies.

However, before you write them off completely, it is worth examining the position from which these countries are coming from. While there is no glossing over the threat of inflation facing most of the emerging economies, it is important to remember that they are entering this phase from a position of relative strength built up over the last ten years. Coming from a platform of strong GDP growth, large FX reserves, limited contagion to the subprime crisis, a growing middle-class and a substantial local savings pool; emerging markets are arguably better placed to withstand the current climate and generate better risk adjusted returns than some developed markets.

Most central banks in EM have been aggressively attempting to fight inflation, evident from the recent interest rate hikes seen in countries like Indonesia, the Philippines, Taiwan and Vietnam. Unlike the US, which faces a threat of stagflation as it tries to fight inflation while attempting to shore up growth, EM are able cut rates and let their currencies appreciate because of strong growth and substantial FX reserves. According to the latest post-credit crunch forecasts from the IMF, growth across EM should reach 6.7% this year and expected to be 6.6% next year against 1.3% per annum across developed economies.

Emerging economies have the added advantage of being buoyed by growing affluence and a strong local savings pool. According to the latest Annual World Wealth Report by Merrill Lynch and Capgemini, entrepreneurs in countries like Brazil, Russia, China and India enjoyed a greater surge in capital than the US, UK and other developed countries in 2007. Brazil has the third-fastest growing HNWI growth, expanding by 19.1%, while net private capital flows to Latin America doubled in 2007. Russia was also one of the world's 10 fastest-growing HNWI populations as growth remained strong at 14.4% in 2007, marginally down from 15.5% in 2006. "Gains in commodity exports, paired with growing international acceptance of emerging financial centres as significant global players, contributed to growth rates," the report stated.

Owing to their comparatively less mature capital markets, emerging economies were also better protected from the subprime meltdown and the ensuing credit crunch. The structured finance market is relatively under-developed in these economies and following the 1998 crisis, many investors have exercised greater caution when investing in these markets while local fiscal policy has substantially improved. As a result, the large scale excesses that have become typical of the capital markets in the US and certain European countries have not been mirrored in emerging countries.

In light of such factors – lower household and corporate sector leverage, high company profitability, appreciating currencies, large FX reserves and strong domestic economies – investors are showing greater discernment in valuing emerging market assets.

Local Currency Debt: An Insulated Investment Proposition

Across most EM economies, local debt is still proving to hold its value against wider economic concerns with emerging market debt significantly outperforming emerging market equity strategies. According to the EurekaHedge Hedge Fund Index, emerging market distressed debt hedge funds have returned -3.1% year-to-date as at the end of August 2008 while the EurekaHedge Emerging Market Equity Long/Short index is down significantly more with -15.6% over the same period.



A large part of the strategy's performance is being driven by the attractive yields in local currency debt and the dispersion between bonds of different duration backed with active hedging. The discerning investor is beginning to realise that with local captive liquidity, a weakening dollar and EM's large pipeline of shorter term assets; local debt products are looking like attractive investments over assets in developed markets given wider market concerns.

A strong domestic pool of liquidity, fuelled by a growing institutional investor base, is encouraging a greater number of local currency issuance within EM countries. Countries like Russia, Chile and Brazil have built up large captive pools of domestic liquidity over the last 20 years and are refinancing sovereign and external debt in the local markets.

The trend in Brazil in recent years has been towards growth in domestic markets rather than overseas placements, which is being driven by a large number of companies pegging their costs to the Brazilian real. In the first half of this year, Brazil's overseas debt placements amounted to US\$6.4 billion, down US\$7.52 billion compared with last year.

Additionally, with local markets fearing a slowdown in the US economy, rising inflation and the prospect of further interest rate hikes, investors are turning their attention away from equities, further fuelling the domestic savings pools and consequently the local fixed income markets within some of these countries.

The threat of inflation is in fact better managed using domestic bonds because of its shorter duration. Additionally, local currency issuers are also more likely to accept a lower coupon if they take the view that currencies will appreciate further, which seems to be the consensus across most emerging economies.

Furthermore, the decline of the dollar in terms of its value and in terms of its influence in an increasingly multi-currency market, is lending further strength to local currency debt markets. It is less susceptible to the whims of the external markets, which have historically adopted a "love-hate relationship" with external emerging market bond issues.

The market's inconsistent reception to hard currency issues was illustrated recently when Ukraine was forced to suspend its Eurobond sale because of a serious fall in the cost of Ukrainian Eurobonds already on the market. The drop in value of the bonds is the result of the country's lower credit rating and an increase in world oil and gas prices. Foreign investors rely heavily on the views on ratings agencies and such downgrades go a long way in dampening confidence in the country.

Strategic Differentiation

Under current market conditions, the discrepancy between emerging economies and in bonds of different duration, are producing excellent relative value opportunities. However, such discrepancies also suggest long credit opportunities in EM must be considered on a country-by-country basis or protected with an active hedge. In other words, it helps to show greater differentiation when deciding which EM credit to go long.

The surge in commodity prices has weakened the economic fundamentals of some EM, but benefited others. Most countries in Latin America have benefited from rising commodity prices although they have suffered symptoms shared elsewhere in EM, eg currency appreciation, inflation and in some cases weakening external balances.

The risks, however, seem most pronounced in Asia where the combination of political controls and fiscal measures could lead to greater distortions in the longer term. Many governments in Asia have reduced fuel subsidies prompting central banks in countries like India, Indonesia and the Philippines to raise rates to combat a fresh burst of inflation. Asia's trade surplus has also narrowed since last year, which is also taking its toll on Asian economies. Countries with a large current-account deficit suffer greater risk as it relies on foreign capital to boost investments.

On the other hand, there are countries such as Russia, which stands in good stead to withstand deterioration in the wider global markets. The country has not issued debt in the foreign market for the last five years. Russia is sitting on the world's largest pool of FX, so it does not need to push liquidity into the economy. Its economy is also poised for further GDP growth. Russia's Economy Ministry is projecting GDP growth at 7.8% in 2008 while expecting lower inflation.



“Overall, while risks in EM are on the rise and we expect more worrisome indicators for the next few quarters, we consider them relatively limited and unlikely to be systemic,” according to Lehman Brothers research entitled Global Economics, 26 June 2008.