

Emerging Markets in 2009

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Along with most asset classes, 2008 was a very painful year for Emerging Market equities and bonds. The global credit crunch disproved the decoupling theory as, in times of financial stress, correlations of many financial assets tend towards one. But should Emerging Markets have been affected as badly as they were?

Emerging market economies have developed from being able to provide most of the world's strategic natural resources into a plentiful supply of labour and low costs of production. These factors combined to support the demand in the developed world for goods and commodities at reasonable prices. The wealth created by these exports fed back into the domestic economies in the form of higher economic growth, increasing reserves and rising per capita GDP. As the credit crunch has taken hold the demand for raw materials and consumer goods has declined sharply and the price of commodities has fallen sharply.

Under these circumstances, if they had taken place five years previously, Emerging Market economies and financial markets could have been expected to have suffered significantly more than they have. This time, Governments in these countries took advantage of the strong export revenues to build up foreign exchange reserves, pay down external debt and create sovereign wealth funds and strategic reserves. They acted prudently by saving for a rainy day, thereby providing some protection against the slowdown currently being experienced.

Although the banking systems in most emerging economies generally had little exposure to the toxic assets which have wrought such havoc in the developed world, the shortage of credit globally is having an impact on the ability of emerging market banks to provide facilities for their customers. This problem is not unique to the Emerging Markets; but where they differ from the developed world is in the ability of governments to provide liquidity

and support to their economies from their strategic reserves rather than increasing levels of national borrowing.

Emerging market equity and bond markets in the second half of 2008 and into the first quarter of 2009 reflect the uncertainty in investors minds over the magnitude and extent of the economic downturn. GDP forecasts for 2009, according to Consensus Economics, have now turned negative for the world economy since the continuing economic growth in China, India and other emerging countries cannot compensate for the very sharp slowdown in the developed economies.

However a recovery is expected in 2010, as economies respond to the enormous fiscal and monetary packages being implemented around the globe. Although these measures are unprecedented and the actual impact is not yet certain, the more dynamic economies, such as the USA and many Emerging countries, are likely to respond more quickly to the measures.

Financial markets normally pre-empt economic recovery and, assuming that investors believe that the economy will start to show signs of improvement in 2010, markets may well look through the continuing bad current economic data and newsflow and start to recover during the course of 2009. The timing of this will be dependent on when financial systems, primarily in the developed world, stabilise and begin to function 'normally' again.

In the short term, although uncertainty over earnings has made valuations harder to determine, the sharp correction in Emerging Markets has increased their attractiveness relative to where they were twelve months ago. The current market volatility indicates that the bottoming-out process has not yet run its course however we believe that we are currently in that phase.

The structural case for Emerging Markets for the medium term remains intact. The

economies will continue to offer higher economic growth than for developed markets, and the differential is likely to be greater in the future, as the debt burden in the developed economies will constrain economic growth. The fiscal prudence and stability of the past five years has stood these countries in good stead during the downturn and will provide a stronger platform for recovery.

The reasons why investors have gained exposure to the Emerging Markets story are still in place: the demographic advantages of a growing middle class which feeds credit and consumption growth; the development potential for financial markets through the need for capital and investment. This trend has increased the importance of these countries within the global economy over the past ten years and will continue for many years to come.



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