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2010: A year in emerging markets

Allan Conway, Head of Emerging Market Equities, looks ahead to 2010

- Emerging equity market rally has further to go despite strong performance this year
- Emerging economies have taken over from developed as the drivers of the world economy
- Economic fundamentals in the emerging world are much stronger than in developed markets.

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Despite the strong performance of emerging markets this year, we believe that the rally has further to go. Investors are increasingly recognising the structural change that has occurred in the global economy – it is the emerging and not the developed economies that are now driving global growth. Furthermore, economic fundamentals are much more robust in the emerging world, the prospects for earnings growth are very strong and emerging markets are trading at a discount to developed markets. These advantages, coupled with favourable liquidity conditions, add up to a very positive outlook for these markets on a 12-18 month view.

At the beginning of the year, the main concern for investors was 'Are we in a depression?' We have moved on a long way from there and the key question now is 'What is the nature of the recovery we are in?' We believe that the recession that we are just coming out of ended in around July this year – at 19 months in duration, it is the longest recession we have had since the 1930s and also the deepest. There are many signs of recovery coming through. The OECD leading indicator is ticking up, while the US ISM manufacturing index has moved above 50 and the US leading indicator has moved above 100.

Schroders' Economics team has three scenarios for the global economy – a W-shaped recovery (or double-dip), a V-shaped recovery and a slump (or L-shaped) scenario. Our base case (with a 70% probability) is for a double-dip scenario, with the second dip in activity set to be less marked than the first. The reasoning behind this is that the recovery we are now seeing is very much a manufactured one, caused by massive fiscal stimulus (particularly in developed countries), quantitative easing and inventory rebuild. What we are not really seeing is a significant rebound in consumer demand. Hence, there is potential for a double dip in Q1/Q2 next year and we have recently seen concerns about this starting to filter into markets.

Emerging economies set to outperform under any of our global scenarios
Nevertheless, under any of our scenarios, double-dip, V-shaped recovery or slump, we forecast that emerging economies will outperform developed economies. In the past, emerging markets would have suffered far more from a global recession as they were largely dependent on exports. However, over the last 10 years emerging economies have strengthened and have moved up to growing 3-5% faster than the developed economies every single year (this improvement is also highly correlated with strong performance from emerging equity markets over this period).

As a result, emerging markets' share of global GDP growth has been increasing over time. This year they are set to account for over 100% of global growth (as global GDP is set to fall this year but emerging economies overall are delivering growth) and we believe that they will continue to dominate. We would suggest that even with a recovery in the developed world, emerging economies will account for 70-75% of global growth every

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year for the foreseeable future. This is a major structural change, certainly as significant as the Industrial Revolution in the 19th Century and perhaps more so. In the past, the global economy was driven by the developed economies and emerging markets relied on developed world demand for their exports – the reverse is now the case.

Domestic demand increasingly important in driving emerging market growth

It is the growth of the BRIC markets, Brazil, Russia and particularly India and China that is at the heart of the emerging market success story. Taking China as an example, its growth has been a function of domestic demand rather than exports. This is the first time in history that an economy has emerged to become a major world player with domestic demand as the primary driver – previously this kind of development has been export driven (for example the UK, US and Japan). This is occurring as China's huge population is increasingly getting access to disposable income and therefore increasing consumption – retail sales growth in China is much stronger than in the US.

Looking at emerging markets more broadly, car sales in the top 16 emerging countries are now much stronger than in the US, Japan and developed Europe combined. Domestic demand has become an increasingly important driver of growth in the emerging world overall, not just in China, as disposable income increases.

Trade between emerging countries also increasing in importance

Trade between emerging economies is also becoming increasingly important. China now accounts for a larger share of exports from emerging markets than the US. China also exports more to emerging countries than it does to the whole of the G7. Overall, growth momentum in the emerging world is far less reliant on the developed world than in the past.

Economic fundamentals in the emerging world are also much stronger than for the developed markets. The recession we are coming out of was caused by a credit crisis with inappropriate lending and borrowing and over-leverage – this is very much a developed world problem. Household and mortgage debt to GDP is high in the developed world and generally low in emerging markets. In the banking sector, loan to deposit ratios in emerging markets are generally less than 100% – by and large, in the emerging world we have high saving ratios, low levels of debt and prudent lending policies. It is therefore not surprising that very few banks in emerging countries got into trouble – emerging markets generally do not have a recuperation period to go through in the wake of the credit crunch, unlike the developed world.

High government debt levels set to depress developed world growth

Government debt levels are also illustrative – government debt to GDP is forecast to rise to 120% by 2014 (from around 80% in 2007) in the developed world and the resulting higher taxes and spending cuts will depress growth. By contrast, emerging countries are not having to increase their debt levels as, generally, they have not had the same problems as the developed economies. On several other measures such as current account and fiscal balances the fundamentals are stronger in emerging markets – the fundamentals in the developed economies now resemble those of the weak, crisis-ridden emerging economies of the past.

The strength of the emerging economies has been reflected in stockmarket performance this year – these markets are up 77% year-to-date versus 31% for the MSCI World index. However, despite this impressive rally, we believe that there is further to go. Historically, when the US ISM goes above 50 there is on average a rally of around 40% in emerging markets over the next 12 months. Emerging markets have risen since the US ISM went above 50 in August this year, although history suggests that there is another 30% to go. Valuations in P/E terms are at around 13.5 times, which is about the historical average level, although these markets are trading at a discount to developed markets. Furthermore, we are expecting earnings growth of around 30% next year – so a 30% market rally would not lead to stretched P/Es. We also believe that given the transformation we are seeing in the emerging world, these markets will be moving to a premium to developed markets.

Favourable liquidity trends positive for emerging markets

The argument that the emerging market rally has further to go is reinforced by expected liquidity trends. Although we have had well over $US50bn (and rising) in inflows into

Alan Conway, Head of Emerging Markets Equities

Allan joined Schroders in October 2004 as Head of Emerging Market Equities.

He is a Fellow of the Securities Institute (FSI), Member of the Institute of Chartered Accountants (ACA) and has a BA (Hons) Degree in Economics from York University.

His investment career began in 1980 and he has worked at companies including WestLB Asset Management (where he was Head of Global Emerging Markets and later Chief Executive Officer of WestAM (UK) Ltd) and LGT Asset Management (where he was Head of Global Emerging Markets).

emerging markets so far this year, this has merely replaced the record outflows we saw during last year's sell-off. A key positive we have observed this year is a substantial shift in the attitude of institutional investors towards emerging markets. In the past, institutional investors generally viewed emerging markets as high risk/volatile in nature and as a tactical investment, buying into these markets during periods of positive market conditions and selling out of them when conditions deteriorated. However, we are now seeing a significant increase in interest in emerging markets from these investors. We have just gone through the worst economic crisis since the 1930s but the emerging economies have generally come through it in stronger, not poorer, shape. As a result, institutional investors are now increasingly regarding emerging markets as a strategic rather than a tactical investment.

The overall liquidity environment is also favourable, given the huge quantitative easing programmes we have seen. Although some central banks are talking about a potential exit strategy, we believe that they will come to this later rather than sooner – they do not want to take risks with growth and would prefer to risk inflation. Therefore, we believe that favourable liquidity conditions are set to continue for some time, and given their attractions, emerging markets are likely candidates for a bubble (although it will be some time before we see bubble conditions).

In the near term, we would not be surprised to see a setback in emerging markets, with the trigger for this likely to be the factoring in of a double dip scenario for the global economy. We would not expect the size of the setback to be more than 10-15% and believe it would be short and sharp as investors are likely to buy on the dips. Overall, given the attractions of emerging markets, we are very positive on the outlook on a 12-18 month view.

Dollar rally would be a risk but we are not expecting sustained strength

One of the risks to the favourable outlook for emerging markets would be a bounce back in the US dollar. A weak dollar is positive for these markets as easier US monetary conditions support global liquidity, which tends to be attracted to faster growing economies. However, although a short-term rally in the dollar is a possibility, we do not expect sustained strength. The underlying weakness of the US economy is undermining the currency, while the countries with the largest foreign currency reserves have each stated that they are looking to diversify away from the dollar over the next few years. The changing pattern of trade flows should also mean that the dollar weakens and emerging market currencies appreciate (as the emerging markets are becoming more important than the US in global trade).

A longer-term risk would be a lack of 'trickle down' in emerging countries. As rapidly developing economies such as China and India grow, it is important that an increasing proportion of the population gets the benefit of this growth. If wealth in these countries is not spread quickly enough there is a risk of social unrest. Although this remains a longer-term concern for several emerging countries, there are signs that it is being addressed. The Chinese government in particular is aware of this issue and is trying to tackle it with, for example, increased government spending in rural areas.

In summary, we believe that the considerable advantages of the emerging markets over the developed world should continue to attract investors. Taken together with a likely continuation of favourable liquidity conditions, we believe that the prospects for these markets are very positive on a 12-18 month view.

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