

Schroders Talking Point



Emerging market rally has further to go

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Although emerging equity markets delivered impressive returns (79% in US dollar terms) in 2009, we believe there is further to go for these markets. While potential for near-term volatility remains, we are expecting strong returns on a medium-term view, given their excellent growth prospects and robust fundamentals compared to the developed world. Indeed, we would expect valuations to move to a premium to developed markets. Furthermore, as global liquidity conditions are likely to remain favourable, these markets are prime candidates to benefit from an asset price bubble.

Looking first at the global economic backdrop, we are clearly into a period of recovery, following the longest and deepest recession we have had since the 1930s. The key question now is what type of recovery are we in? Schroders' Economics team expects a 'W-shaped' recovery, where the US delivers GDP growth of around 2.2% this year. The risks are on the upside, however, and there is a good chance that US growth could come in above 3%. Nevertheless, this would still represent an anaemic recovery - given the magnitude of the recession we have just gone through, we should be looking at US growth of between 5-6% this year.

Emerging economies set to perform better than developed

We expect emerging market economies to deliver significantly stronger growth than developed economies this year and for many years to come. Last year, while global growth was -2.1%, emerging markets overall avoided recession, growing by 1.1%. For many, that is quite a surprising result, because looking at the last 50 years, one would be led to expect that emerging economies would suffer more if there is a recession in the developed world. However, as we saw last year, although the emerging market economies slowed down, they significantly outperformed and they are expected to continue to do so.

In the past, the emerging economies relied on the developed world for their growth, as they were export-led, for example Japan in the 1960s and Korea in the 1980s. That is why if there was a slowdown in the US or Europe those emerging countries would have felt it far more severely because they relied on exports. However, turning to the emerging economies of today, growth in China, for example, is being primarily led by domestic demand and not exports. This picture is unique - in the past, all emerging countries, when they were going through their period of rapid growth, did so primarily through trade. The fact that the Chinese economy is being driven by domestic demand rather than exports is one of the reasons why it has been able to come through with strong growth despite the slowdown and recession in the developed world.

Looking at this domestic demand story in more detail, several commentators have been saying that a lot of Chinese domestic demand is led by fixed capital investment - spending on infrastructure.



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The claim is that China is spending too much, it is overbuilding, there is excess capacity and this is a 'house of cards' waiting to fall down. We believe that this argument is completely wrong. China spends about 40% of its GDP on fixed capital investment every year. When we compare this to what Japan was spending in the 1960s or Korea in the 1980s, it is clear that China is spending at around the level it needs to in order to achieve sustainable growth.

But the domestic demand story is not only about capital investment. There is very strong consumer demand coming through in China. Chinese retail sales growth overtook that in the US in 2006 and car sales in China grew by 50% last year - while US car companies were looking to the government for bailouts due to the collapse in demand, people wanting to buy a car in Shanghai or Beijing had to go on a waiting list!

Rising consumer demand in the emerging world is transforming the global economy

This is not just a Chinese story. Looking at total car sales in the top 16 emerging countries, more cars are now sold in these countries than in the whole of the US, Europe and Japan combined, while last year more Porsche cars were sold in Russia than in the US. Overall, the increase in domestic demand we are seeing in the emerging world is a powerful trend that applies to a whole range of consumer goods as people start to get disposable income - not just cars, but TVs, washing machines and mobile phones. What we are seeing, in China and India particularly, is an extraordinary event. It is transforming the global economy and we would suggest that it is even more important than the Industrial Revolution in the 19th Century as far as the global economy is concerned.

Although exports have become less of a driver for the emerging economies, they are still of importance. But we are seeing a major change in the profile of exports. In the past, the pattern was for the bulk of exports from the emerging world to go to the developed world. What we have seen over the last 10 years is a declining trend in the share of emerging market exports going to the US and a rising trend of emerging market exports going to China. Today, far more exports from emerging market countries go to China than the US. China also exports far more to other emerging countries than to the G7 countries.

Emerging economies to account for 70-75% of global growth for the foreseeable future

We believe that economic historians in 100 years time will look back at the period we are living through now and identify this as the time when economic power shifted from the US and the G7 to China and India. No longer are the developed economies, led by the US, driving the global economy, now the emerging markets are the drivers of global growth. We would suggest that emerging markets will be accounting for 70-75% of global growth every year for the foreseeable future.

Another key factor in favour of the emerging economies is that they are relatively unencumbered by debt. The over-leverage, inappropriate borrowing and inappropriate lending we have seen in the developed world has not, by and large, been mirrored in the emerging countries. In the developed world, household and mortgage debt to GDP is much higher than in the emerging world. Corporates in the emerging markets are also generally less indebted than in the developed markets.

As for the banking sector, although we have seen a series of major bank bailouts in the US, UK and Europe, it is no coincidence that we have hardly seen any emerging market banks get into trouble. Average loan to deposit ratios in banks across the emerging world are below 100%. What has characterised emerging countries has been high savings ratios, low levels of debt and banks following prudent, conservative lending policies – they simply did not join in this party.

Government debt will weigh on developed economies but not on emerging growth

The legacy from this crisis is government debt levels in the developed world - in the next few years the level of debt to GDP in the developed world will increase to over 100%. This means there will be a massive weight on the developed economies in terms of their growth potential – some economists in the US are estimating that US trend growth has declined by 0.5% as a result of this crisis. However, for the emerging markets, the level of government debt to GDP is set to decline slightly over the next few years - we are looking at a fraction of the levels of debt in the emerging world compared to developed. Overall, given their considerable advantages, we are confident that the emerging economies can maintain a growth differential of 3-5% p.a. over developed for the foreseeable future.

What has been outlined so far is essentially the decoupling story – the story that emerging markets have changed and are able to grow without depending on the developed world. Although there has been a lot of scepticism about the decoupling story in recent years, we believe that the argument has now been won. Decoupling has clearly taken place – it is why last year emerging market economies came through so much stronger than developed. But looking at the performance of emerging equity markets in 2008, several commentators have said that emerging markets cannot have decoupled because they underperformed in the sharp market sell-off we saw in that year. However, this does not disprove decoupling – the reason emerging markets underperformed in 2008 in our opinion was largely profit taking – it was the one place where investors had good profits. Over the 10 years to the end of 2009, developed markets have delivered an overall return of 2%. Over the same time period, emerging market equities have delivered returns of 162%.

Emerging market valuations likely to move to a premium to developed markets

Given the strong performance we have already seen from emerging markets, is all the good news in the price? Emerging markets today are on a prospective P/E of around 13 times and we are forecasting earnings growth of around 30% this year – a P/E to growth ratio of below 0.5. Despite the 79% rise in these markets last year, the prospective P/E is in line with the long-term average. These markets were massively over-sold in 2008 and all that the rally has done is to take them back to long-term average valuations - combined with superior earnings growth that is an attractive picture.

We are expecting emerging market valuations to settle into a premium to developed markets in the years to come. Indeed, over the next year or two we expect these markets to become over-valued – they are prime candidates for an asset-price bubble. There is a huge amount of liquidity in the financial system and this money is not going to be withdrawn too quickly, as central banks will not want to undermine a currently anaemic recovery. These favourable liquidity conditions are likely to fuel asset price bubbles and the most likely candidate, in our opinion, is emerging market equities. We are already seeing huge flows into these markets and although it is impossible to forecast a bubble with any precision, we may well see prospective P/E's being driven up to 18 or 20 times over the next year or two.

Potential for near-term volatility, but strong upside on a medium-term view

However, we are a little cautious about the outlook over the next couple of months. This is because US data is pointing to stronger-than-expected growth in the near term and consequently the US dollar is strengthening, which, together with the modest tightening of monetary policy which is underway in some emerging economies, creates the potential for a degree of short-term profit taking. We have already seen some of this playing out although we expect the downside for emerging markets to be relatively limited, maybe 10-15%. Looking further out, we believe that emerging markets have a lot more upside, given their considerable attractions.

Potential lack of ‘trickle down’ a longer-term concern – although this is being addressed

A longer-term risk would be if wealth fails to ‘trickle down’ in emerging countries. As the rapid growth in these economies continues, it is important that an increasing proportion of the population sees 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.

Another longer-term issue that is sometimes raised, is over the sustainability of emerging market growth, given environmental concerns and potential constraints on, for example, carbon dioxide emissions. We believe that emerging countries have an important advantage over developed in this sense because they can bring new, ‘cleaner’ technology to bear during their period of rapid investment. They will not have to ‘deconstruct to reconstruct’ their economies unlike the developed world, they will be able to put a lot of the appropriate measures in place as they are building. There is also, we believe, increasingly an acceptance in the developed world that the burden of dealing with the environmental pressures caused by economic growth should be shared, and not just put at the door of the rapidly growing emerging world.

In summary, we believe that even though we have already seen excellent performance from emerging equity markets in 2009 and there continues to be potential for near-term volatility, these markets have strong upside potential on a medium-term view. Their excellent growth prospects and robust fundamentals compared to the developed world are increasingly attracting investors, and the likely continuation of favourable liquidity conditions may well fuel a bubble in these markets.

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