

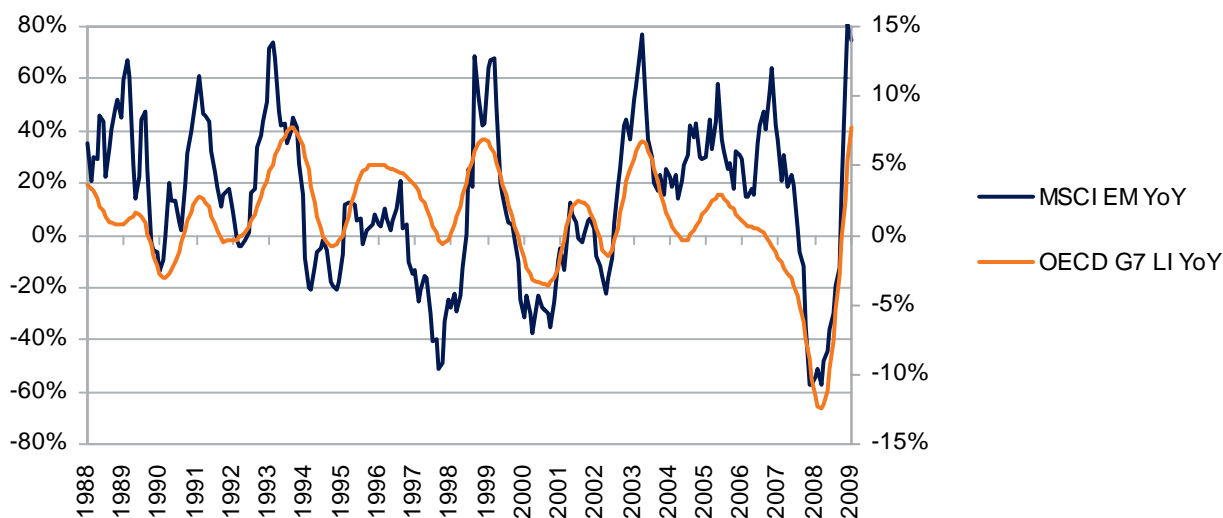
Schroders Talking Point



OECD leading indicators and emerging markets

Nicholas Field, Emerging Market Fund Manager/Strategist and Allan Conway, Head of Emerging Market Equities

When economists and strategists talk about the future direction of emerging market equities they frequently produce charts like this – the year-on-year change in emerging markets plotted against year-on-year changes in the OECD G7 leading indicators.



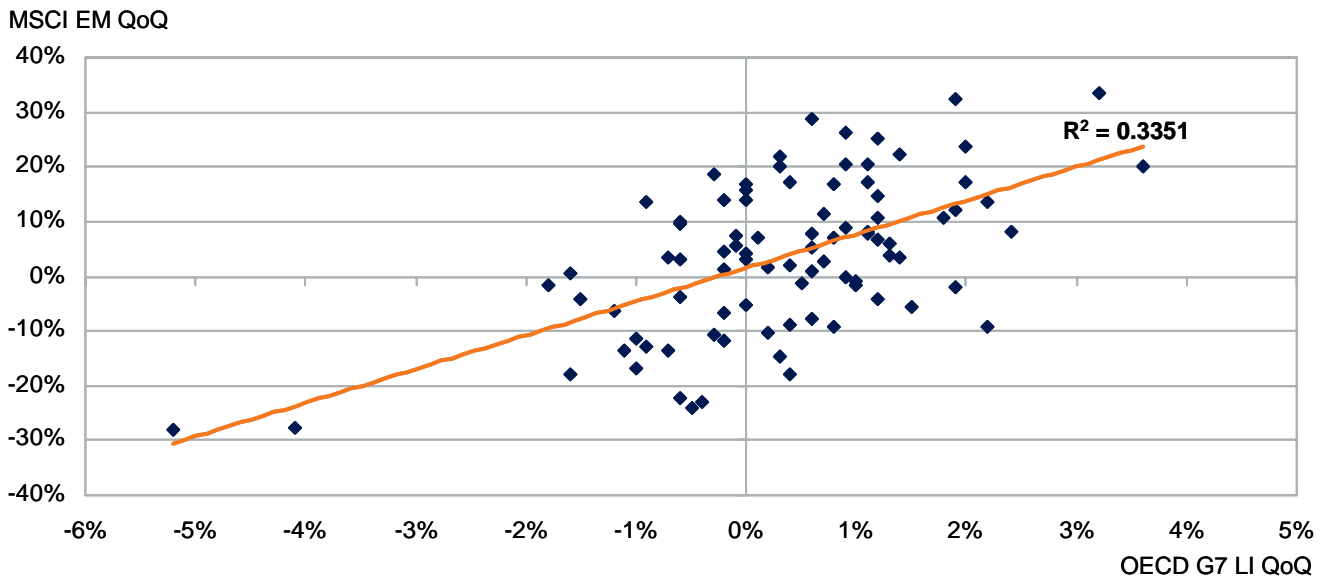
Source: Datastream. MSCI/OECD. March 2010

Such charts look compelling, and are frequently used to justify arguments about whether it is the right time to be in emerging markets, or on the hoary old chestnut of ‘decoupling’. This paper takes a more detailed look at the relationship between developed market leading indicators and emerging market performance.

Simple correlations

Year-on-year data shows strong correlations between OECD leading indicators and emerging markets – nearly 60%, as the above chart seems to indicate. Even more impressive, we see similarly strong correlations when we look at quarterly data. Not only is the correlation high, but a regression shows how linear the relationship is, with a high R-squared.





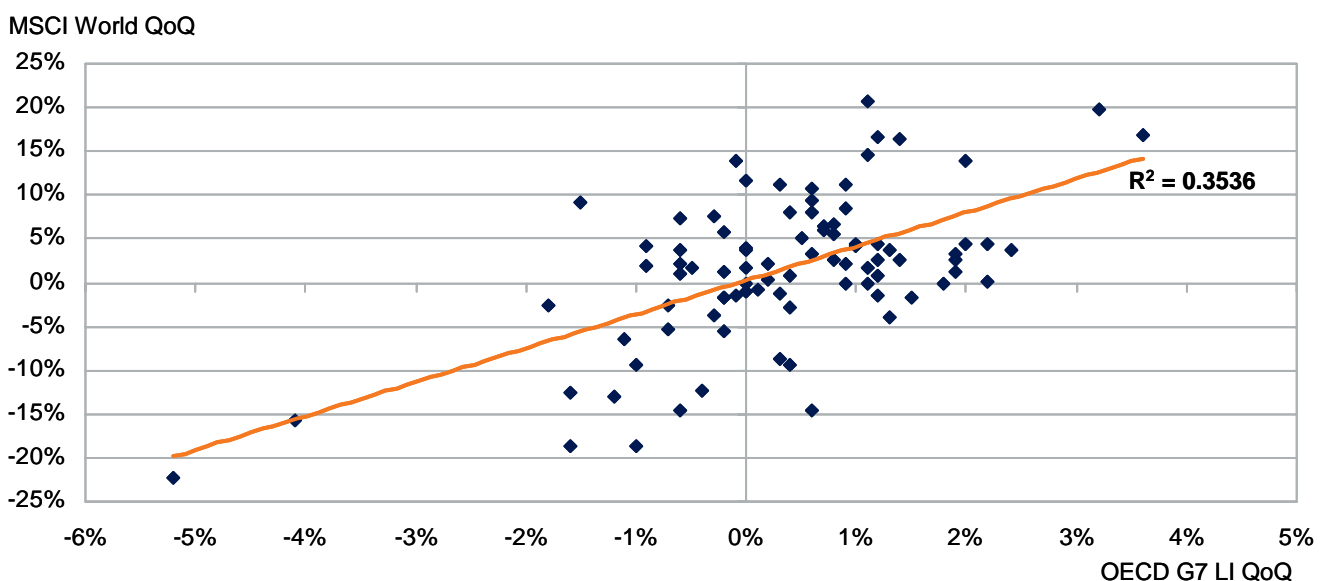
Source: Datastream. MSCI/OECD. March 2010

This is contemporaneous data. The claims made about the usefulness of OECD leading indicators are that they are predictive of emerging returns. We can test this by lagging the market return by one quarter relative to the OECD data. The results are less impressive. Correlation drops to 20%, R-squared is only 4% and the T-stat shows that the relationship is barely statistically significant (just under two).

So the leading indicator is not good at predicting emerging market returns. Interestingly, when lagged the other way, the data suggests that emerging market returns are reasonably good at predicting the leading indicator. This seems to be consistent with the result in our previous paper on GDP and markets – that markets are better at predicting GDP than the other way round. Here we have a result that markets predict the leading indicator which, in turn, predicts GDP. Have we just demonstrated that emerging markets predict G7 leading indicators and growth? That seems a little odd. This is what we need to examine next.

Relative performance

Emerging markets seem to move in line with the OECD G7 leading indicator. Not surprisingly, developed markets also move in line with the leading indicator. Here is a scatterplot of quarterly developed market returns against the leading indicator.



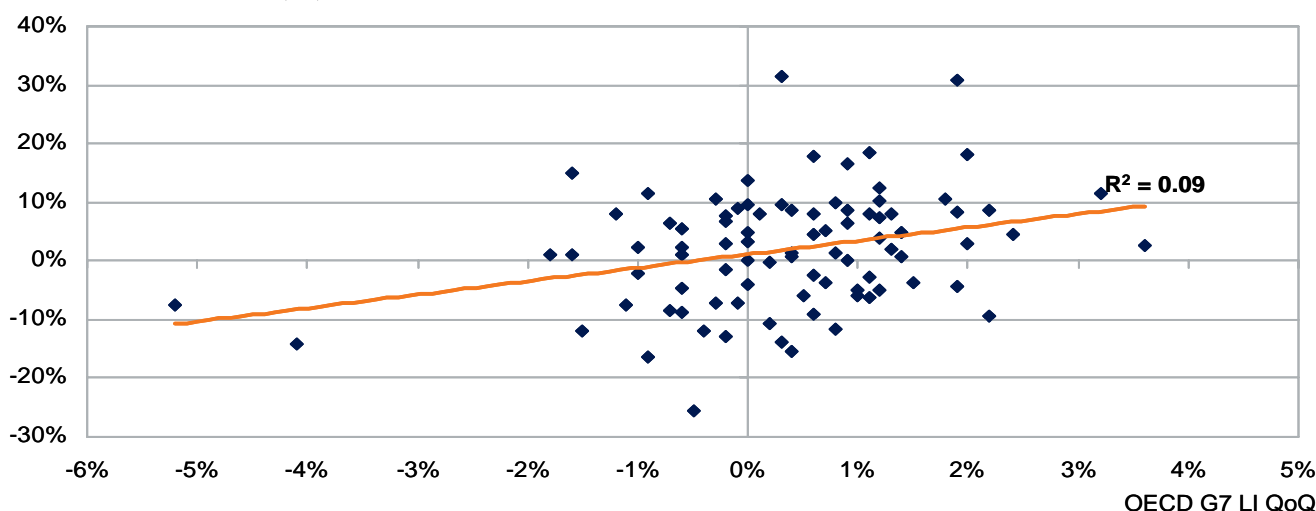
Source: Datastream. MSCI/OECD. March 2010

It is hard to see the difference between this chart and the previous one for emerging markets.

All this shows is that there is a high correlation between all global stockmarkets and leading indicators. In an ever freer global capital market, not even the most ardent 'decoupler' would suggest that any country's market can be completely unaffected by events in the world's large economies and markets. A correlation of zero can only occur in markets which are largely closed to external investment. Despite this, a strong short-term directional relationship does not preclude long-term divergence. Over the last ten years, the tendency is for emerging markets to go up in a quarter when developed markets go up and down when they go down. That has not stopped them from returning 10% per annum against 0% for developed markets.

Is there any evidence that the OECD G7 leading indicator has any greater relationship with emerging stockmarkets than it does with developed markets? To test this we need to look at the leading indicator against the relative performance of emerging to developed.

MSCI EM / MSCI World QoQ



Source: Datastream. MSCI/OECD. March 2010

It is immediately apparent how much worse the relationship is than that between unadjusted emerging market returns and the leading indicator. Correlation is only 30% and the T-stat drops from nearly seven to under three. A weak result, but there is still some significance here.

If we look at the leading indicator as a predictor of emerging returns relative to developed we find no relationship whatsoever. In other words, regressing the quarterly change in the leading indicator against relative emerging returns for the following quarter produces R-squared and T-stats of zero. So OECD leading indicators convey no information on the relative performance of emerging versus developed markets.

What are leading indicators?

Can leading indicators be expected to have any sort of relationship to emerging market returns? What, actually, are they?

The OECD constructs leading indicator indices for all of its members. It then aggregates them into various groups using a GDP weighting (at PPP exchange rates). So it has a G7 indicator, a euro area indicator and a total OECD indicator. Each individual country index is made up of different things, depending on the data available in that country. We'll take a look at the US indicator, as representative of the sorts of things in a leading indicator and, of course, as the dominant member of the G7.

The US leading indicator consists of:

- Purchasing Managers Index – an indication of what industrial buyers plan to buy in the near future.
- Home starts – an indication of residential construction planned for, but yet to happen.
- New orders – an indication of industrial sales made but not yet delivered on (should be the other side of the Purchasing Managers Index numbers).
- Consumer sentiment – survey data. Generally thought to predict future consumer spending.
- Hours worked – if this is high it should result in higher income and hence higher consumer spending.
- Stock market returns.
- Interest rate differential. Yield curve steepness

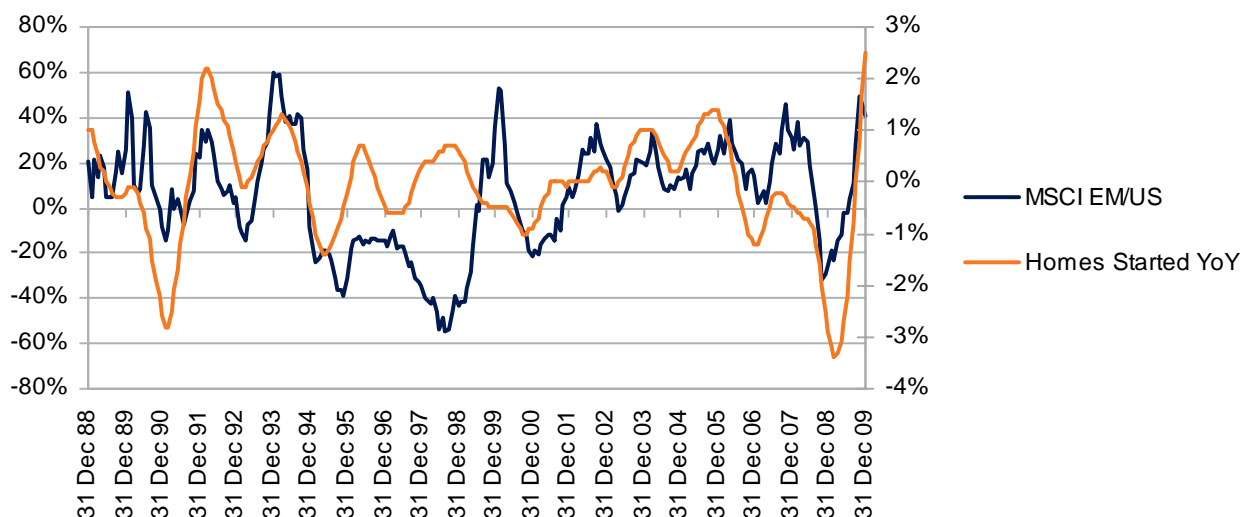
If we work through quarterly regressions of these factors on contemporaneous data for emerging performance relative to MSCI US, we get the following R-squared and T-stats:

	R-Squared	T-Stat
PMI	13%	3.6
Home starts	10%	3.1
New orders	6%	2.4
Consumer sentiment	6%	2.4
Hours worked	10%	3.1
Stockmarket	5%	2.1
Rate differential	3%	1.7

Source: Datastream. MSCI/OECD. March 2010

Quite a lot of these seem significant. Here is the chart for US homes started against emerging market returns relative to the US. It looks as though there is some relationship. Given the variables concerned why should they be connected at all? We can invent some obscure reasoning - home starts lead to increased expectation of Chinese plasterboard imports, or some such - but it is increasingly stretched reasoning.

Year-on-year relative emerging market performance vs US L.I. component



Source: Datastream. MSCI/OECD. March 2010

The least significant of the factors are the two market indicators. Since we are regressing the 'detrended' emerging market returns (i.e. relative to the US market), perhaps this is not surprising. The fact that the US PMI is significant should be some comfort to those who do not believe in

decoupling, since they can argue that this shows US industrial orders help drive emerging markets. Perhaps the same can be said for new orders. But what about the rest? These seem to be purely domestic US indicators and should not be expected to convey any information about emerging stockmarkets.

It is not uncommon for two wiggly lines in economics to look similar. That does not mean there is any causal connection between them. More likely is that these relationships are coincidental - in other words both the US indicators and the relative performance of emerging markets are related to a third, underlying factor. We have a possible candidate for that factor; US monetary policy, as expressed through the strength of the dollar. We will explore this relationship in more detail in our next paper.

Conclusion

We have found:

1. OECD G7 leading indicators appear related to emerging market returns. However, they are also related to developed market returns:
 - a. There is little evidence for a special relationship between the leading indicators and emerging markets other than that of the relationship between leading indicators and stockmarkets generally.
 - b. the leading indicator has no predictive power.
2. Looking in more detail at the components of leading indicators does not shed any light on what is driving any relationship that does exist between them and emerging market relative returns - things that might have been expected to be significant are not, and vice versa.
3. It seems more likely that both emerging relative returns and the components of the leading indicator are both responding to a deeper relationship with US monetary policy and the US dollar. We will explore this relationship in our next paper.

So, OECD leading indicators are not a particularly good indicator for emerging markets. The relationship they have with emerging markets is largely coincidental. If one wanted to explore the relationship between developed and emerging markets, we would argue that the leading indicator is not the place to start - instead you should look at US monetary policy/the US dollar.

Important Information:

The views and opinions contained herein are those of Nicholas Field, Emerging Market Fund Manager/Strategist and Allan Conway, Head of Emerging Market Equities, and may not necessarily represent views expressed or reflected in other Schroders communications, strategies or funds.

For professional investors and advisers only. This document is not suitable for retail clients.

This document is intended to be for information purposes only and it is not intended as promotional material in any respect. The material is not intended as an offer or solicitation for the purchase or sale of any financial instrument. The material is not intended to provide, and should not be relied on for, accounting, legal or tax advice, or investment recommendations. Information herein is believed to be reliable but Schroder Investment Management Ltd (Schroders) does not warrant its completeness or accuracy. No responsibility can be accepted for errors of fact or opinion. This does not exclude or restrict any duty or liability that Schroders has to its customers under the Financial Services and Markets Act 2000 (as amended from time to time) or any other regulatory system. Schroders has expressed its own views and opinions in this document and these may change. Reliance should not be placed on the views and information in the document when taking individual investment and/or strategic decisions. Issued by Schroder Investment Management Limited, 31 Gresham Street, London EC2V 7QA, which is authorised and regulated by the Financial Services Authority. For your security, communications may be taped or monitored.