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Stock Market Weekly

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The Emerging Market Craze

When the term “emerging market” was coined in 1986 by the International Finance Corporation, a subsidiary of the World Bank, there were only six markets (Mexico, Singapore, Malaysia, Hong Kong, Thailand and Philippines) opened to the foreign investor. Today, there are more than 50 such markets ranging from Cambodia to Brazil. Most of us today are familiar with the prominent emerging markets, such as Brazil, Russia, China and India (the BRIC countries).

It is evident today that more and more investors are reducing their cash holdings and steadily putting their funds to work for them in higher yielding assets such as equities. For the week ended Aug. 28 2009, there was a net outflow of $5.75billion from Money Market funds. This brought the year-to-date redemption from these funds to about $250billion. This represents about 50% of what was committed in 2008 to such investments.

There seems to be a trend that investors are favoring placing funds in emerging markets as opposed to developed markets. Thus far, we would have seen that:

- World equities in the developed markets such as the US have advanced year- to-date as much as 11 percent while in markets such as China, Brazil and India advances of 40%, 68% and 65% respectively.

- The Japanese Government Pension Investment Fund, the largest fund in the world, which, as at the end of March, managed about 117.6 trillion yen ($1.2trillion) in assets, is considering investing in stocks from countries such as China and India at the start of their next financial year, April.

- The Norwegian Oil Fund, which is worth about $230bn and consists of funds generated from the country’s oil reserve, is currently seeking emerging market managers to run between $50m - $250m in equity mandates, which would be focused in areas such as: Thailand, China, South Korea and India. They already have managers, such as Prosperity Capital for the mainstream emerging markets like Russia.

Why is there such an interest in the emerging markets?

Emerging markets contain about 80% of the world’s population and create 50% of the world’s output. It is expected by 2050 that the BRIC countries will be among the world’s six biggest economies along with Japan and the US. China is expected to overtake the US and become the world’s most powerful economy over that timeframe.

In the last couple of months, confidence in China's economy has improved as a result of their fiscal stimulus package. China has a growing middle class and has been spending heavily on infrastructure. Up to July 2009, we would have seen that China together with other Asian economies such as South Korea, Indonesia and Singapore would have benefited from their fiscal stimulus packages, the strong financial health of their banks and low private sector debt by households in their region. This is why these economies would have experienced growth in the second quarter by more than an average annualized rate of 10% as opposed to the G7, which contracted by 3.5%. However, by the end of August 2009, the rally seemed to have subsided in these regions as indicated by the Shanghai composite index falling by about 20%. The primary factor behind this is the fear that banks would curb their lending, thus reducing consumer demand for goods and services. Also, there has been an abundant supply of new share issues that has led to a fall in share prices. All of this combined has reduced investor confidence with regard to them holding riskier assets.

Notwithstanding this, China is a powerful economy that will eventually dominate the global market in the long run. It is expected, that as developed economies slowly emerge from the recession the demand for exports from these emerging economies will rise, further enhancing economic growth. Expectations are such that there will be an increase in imports of commodities and agricultural products from economies such as Brazil, Colombia, and Peru. Hence the reason why, commodity sector funds saw an aggregated inflow of $248million for the week-ended August 28th. The resulting inflow has brought the year-to-date investments in these funds to $7.4billion.

Whilst emerging stock markets can yield higher returns, they do carry commensurately higher risk such as lack of transparency and liquidity, price volatility, and diverse financial reporting. These markets tend to be more affected by global investment flows and as money rushes in, their stock markets are the beneficiaries to some of this inflow, positively affecting stock prices. However, investor sentiment can change instantly leaving stock markets to retrace most of their gains. For example, last year, Ecuador chose the course of selective external debt default: This was one additional reason that increased the run on developing markets. As money rushed out, we saw the stock market lost almost all of their gains over the 2005- 2008 period. To illustrate, if we invested one hundred dollars in the Ecuadorian stock market in May 2005, it would have been worth $300 in 2007, but by 2008 that investment would have been worth $100 dollars.

For the investor that is willing to take some risks in their portfolio, it is recommended that they select funds that are managed by reputable companies and diversified not just by sectors but countries as well, such as: Templeton Emerging Markets Fund (TEI), Vanguard Emerging Markets ETF (VWO) or iShares MSCI Emerging Markets Index ETF (EEM).

While the returns and risks of emerging markets are high, it is evident that emerging markets are poised to lead the recovery and maybe a worthwhile investment to consider for the medium to long term period of three to five years.

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