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The end of the emerging market boom?

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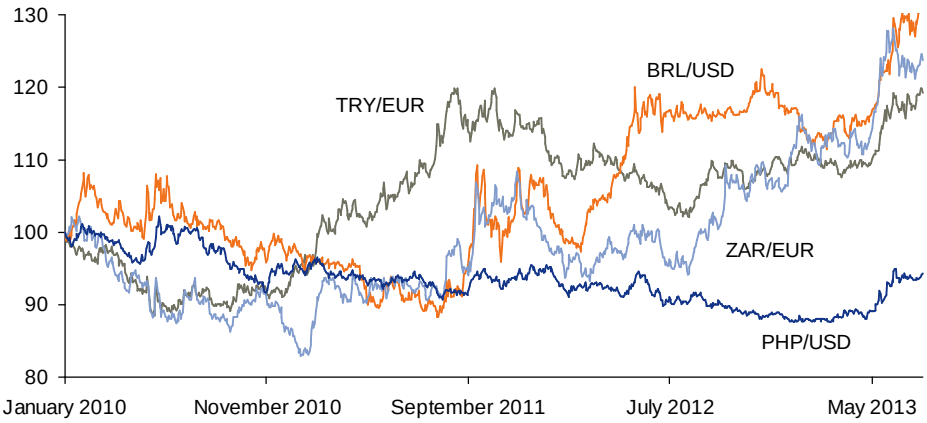
THE END OF THE EMERGING MARKET BOOM?

The emerging markets were long considered the epitome of rampant economic growth and, as a result, a key driver of the global economy. Many emerging markets had done their homework after the numerous crises of the 1980s and 1990s and, thanks to fairly prudent economic policy, made their economies much more stable, rendering them less susceptible to shocks of any kind. One example that is often cited within this context is Brazil. The fact that Latin America's largest economy survived the Lehman collapse and its after-effects largely unscathed was anything but a matter of course. Previous crises, caused either by external shocks or by problems of its own making, had pushed Brazil to the brink of insolvency several times. Brazil owes its improved crisis resilience to a stability-oriented economic policy, the foundations for which were laid by Fernando Henrique Cardoso, initially during his stint as finance minister (1992 to 1994) and later as the country's president (1994 to 2002).

Over the past few weeks and months, however, there has been a flood of bad news from the emerging markets: economic momentum in these countries, for example, has slowed, sometimes considerably so. Additionally, mass demonstrations in Brazil and Turkey have only served to remind us of the political, economic and/or social grievances in these countries. North Africa, home to the countries that spearheaded the Arab Spring, is still a hotspot for worrying news. In Egypt, the situation remains tense and fragile after President Mursi was ousted by the military. If the former president's supporters, particularly the Muslim Brotherhood, cannot carve out an active role for themselves in the political fresh start, it is likely to prove extremely difficult, if not impossible, to get the country back on stable ground.

Emerging-market currencies under heavy downward pressure

Exchange rate developments, index (January 2010=100)



BRL: Brazilian real, PHP: Philippine peso, ZAR: South African rand; TRY: Turkish lira.

Sources: EcoWin, own calculations.

Then, at the end of May, the financial markets in the emerging markets were also thrown into turmoil. The stock markets plummeted and yields on some of the local bond markets started to soar, as did the risk premiums on emerging market foreign-currency denominated government bonds compared with US Treasuries. This market correction triggered a steep slide in numerous emerging market currencies against the US dollar and the euro. Whereas, until recently, some countries were still using restrictions on the movement of capital to ward off any excessive appreciation of their currencies, they suddenly found themselves faced with the predicament of having to intervene on the currency market to prop up their own currency in order to prevent a drastic slide.

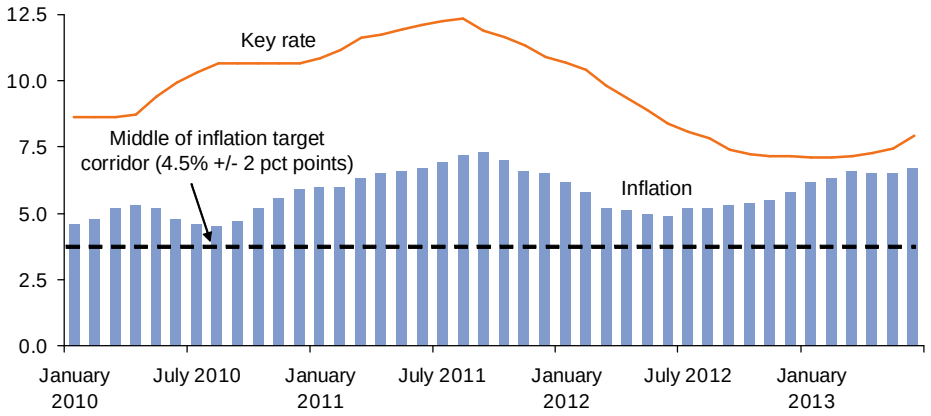
So are we currently witnessing the end of the long-standing emerging market boom and is the global economy poised to lose its main growth driver as a result? Our answer to this question is a clear "no". The emerging markets will continue to deliver significant impetus for the global economy over the next 10 to 20 years. They will continue to clearly outpace the advanced economies in terms of growth. This is because the income gap between the industrial and emerging market economies is still very pronounced and even a rapid catch-up process extending over several decades would likely not be enough to close the gap in full. The emerging markets will continue to shape the division of labor and international specialization patterns; they have considerable reserves of available labor force and diverse investment opportunities at their fingertips. The range of products offered in those emerging markets that have been successful for some time now will become more and more sophisticated. Having said that, new locations for basic, labor-intensive production will emerge elsewhere, too. The transfer of capital will become less and less of a one-way street leading to the emerging markets. Rather, these countries will increasingly start to provide capital to other emerging markets, and also to the industrialized countries themselves. In other words, the emerging markets will become ever more closely entwined with the global economy – a process which, as the numerous emerging market crises, particularly in the 1980s and 1990s, have shown, is obviously still an accident-prone one.

Growth slowdown also due to homemade problems in many places

The fact that growth has currently moved down a gear in many emerging markets partly reflects weaker demand and the manifold consolidation needs in the industrialized countries. In a whole number of emerging markets, however, it is largely "homemade" causes that are to blame for the economic slowdown. The BRIC states, i.e. Brazil, Russia, India and China, are a good example of this. In Russia, for instance, the investment climate has clouded over considerably in recent years, not least due, in all likelihood, to the lack of legal security. In the first quarter or 2013, fixed capital investment was up by only 0.1% on a year earlier, less than at any other time in the past three years.

Brazil: Central bank tolerating higher inflation

Brazil: Key rate (monthly average, in %) and inflation (% chg. on year earlier)



Source: EcoWin.

Brazil's economic development has been a source of disappointment for years now. After real GDP climbed by 7.5% in 2010, growth slowed considerably in the years that followed, closing 2012 at less than 1%. One of the main reasons behind this development has doubtless been the move by the Brazilian government to gradually ditch the stability-focused economic policy it had pursued for years. One of the key elements of this policy was monetary policy aimed primarily at ensuring price stability. In the period between August 2011 and October 2012, the Brazilian central bank slashed its key rate by a total of 525 basis points in an attempt to kick-start the economy and weaken the national currency, the Brazilian real. During the same period, however, the rate of inflation was stuck in the top half of the target corridor (4.5% +/- 2 percentage points), after having been well above the target corridor at the start of the rate-cutting cycle. This monetary policy, with its conflicting goals of promoting growth and battling inflation, will certainly have robbed Brazil of some of its economic policy credibility. The same applies to its fiscal policy, which has become more expansive again in recent years. It would appear that achieving a sustained high primary surplus is no longer deemed to be as important as it was only a few years back. Last but not least, the investments in infrastructure, education and healthcare that Brazil urgently requires are being made, if at all, at too sluggish a pace. The country's inadequate infrastructure, in particular, poses a considerable growth obstacle for the Brazilian economy.

China, the world's second largest economy, faces profound changes to its growth model. Private consumption is to be strengthened and the reliance on the export sector scaled down. At the same time, economic growth in the future is meant to become more sustainable and more balanced. The challenges this involves are enormous. Although China is up to the task, we must bid farewell to the idea of double-digit GDP growth rates. In the medium term, we expect Chinese economic growth to come in at around 6½% a year.

Emerging markets' contribution to global growth still rising

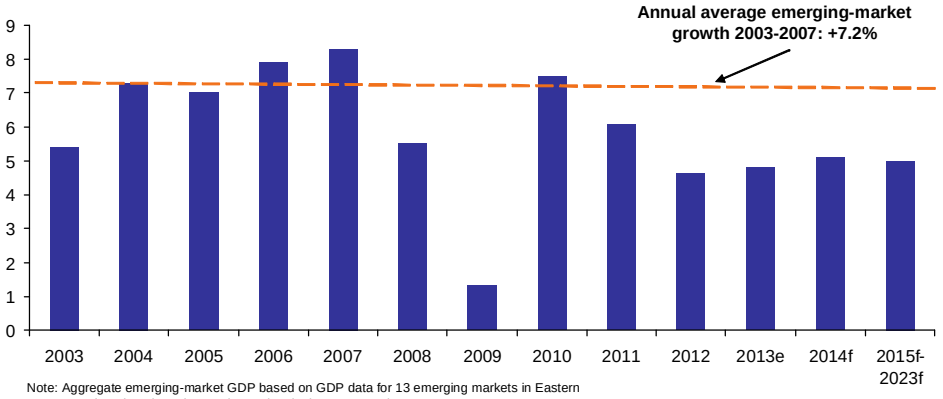
As we have seen from the example of the BRIC states, there are good reasons explaining why the emerging markets have been experiencing somewhat weaker economic development. Their "race to catch up" will, however, continue, fueled largely by the income differential between the emerging markets and their industrialized counterparts. All in all, we expect the group of emerging markets to grow by around 5% a year on average over the next ten years. By way of comparison: in the boom years between 2003 and 2007, the annual growth rate was still sitting at just over 7%. But even with the growth rates expected to tail off, the emerging markets will continue to make the biggest contribution to global economic expansion. Since they now have a much bigger slice of global output than they did only six years ago, for example (2007: 29.6%, 2012: 38.1%; based on current exchange rates in each case), the emerging markets are now actually contributing even more to annual global growth than in the past, in spite of the ebb in momentum.

But there are also positive surprises, namely countries that have emerged as new sources of impetus thanks to their robust economic development in recent years. These include, to name but a few, countries like Indonesia, the Philippines, Chile and Peru. Indonesia, for example, fared surprisingly well during the crisis-ridden year of 2009 thanks to high levels of macroeconomic stability and robust domestic demand, reporting economic growth of around 4½% at a time when the global economy contracted by more than 2%. The Philippine economy expanded by just shy of 7% last year, a rate that is unlikely to drop back to any considerable degree in 2013 and 2014 either. By way of comparison: the annual rate of growth was well under the 6% mark between 2003 and 2007. The southeast Asian country is benefiting, among other things, from what is now a far more solid fiscal policy, which has not only promoted a marked improvement in the investment

climate and, as a result, contributed to higher growth, but also allows the government to pursue an anti-cyclical fiscal policy at times when economic development is looking less favorable without having to risk a loss of credibility as a result.

Despite slowdown, emerging markets remain key driver of global growth

Real GDP growth, %



Note: Aggregate emerging-market GDP based on GDP data for 13 emerging markets in Eastern Europe, 10 in Asia, 7 in Latin America and 10 in the MENA region.

Sources: EcoWin, own calculations and forecasts.

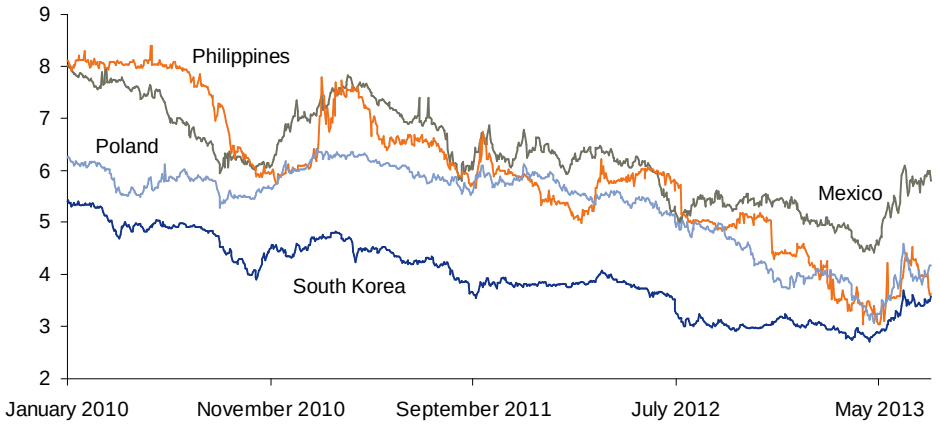
Trigger for capital outflows more likely to lie in the advanced economies

As far as the marked capital outflows from the emerging markets since May 2013 are concerned, we do not believe that these primarily reflect a change in the evaluation of the fundamental data of these countries. Rather, this development was triggered by the abrupt shift on the global financial markets from risk-on to risk-off mode. This change in sentiment came as a direct response to statements made by the US Fed regarding its possible timescale for an exit from its extremely loose monetary policy. After many quarters of liquidity being pumped from the advanced economies into the local stock and bond markets in the emerging markets in a quest among investors to seek out returns, some of these funds are now being withdrawn. In many countries, the yields on 10-year government bonds rose by around 100 basis points. Some of the fluctuations were much more dramatic, however, with yields leaping up by 200 basis points and more in some cases. The exchange rate fluctuations sparked by the capital outflows might have serious implications. There is no doubt that devaluation to the tune of between 10% and 15% within only a few weeks has an impact on real economic development. The inflationary impetus associated with the devaluation could, for example, require the monetary policy reins to be tightened at a time when lower interest rates would actually be helpful in order to kick start the economy.

The increase in yields also has to be seen, at least partially, as a necessary return to normality. Let us take the bond market in the Philippines as an example: in early 2010, i.e. at the start of the European sovereign debt crisis, the yield on 10-year government bonds issued by the Philippines was still sitting at around 8%. The annual rate of inflation was around 4.3% back then, putting the real yield on 10-year government bonds at roughly 3.7%. In mid-2013, yields dipped to an all-time low of 3%. After deductions to reflect the inflation rate, the yield on Philippine government bonds came in at no more than 0.4% in real terms. This sort of drop in the real yield level certainly cannot be explained by the development in the macroeconomic fundamental data between 2010 and 2013 alone, but is more likely due to a massive inflow of foreign capital into a comparatively small local bond market.

Global hunt for yields – key factor behind recent rally on local bond markets

Yield on 10r government bonds, in %



Source: EcoWin.

All told, we do not view these capital outflows as an alarm signal for the long-term outlook – at least as far as most of the countries are concerned. The emerging-market "growth story" remains basically intact. The correction on emerging-market financial markets will therefore prove short-lived. Given the growth potential outlined above, these economies will remain attractive for investors in the future as well. To this extent, the present consolidation phase could well provide some interesting openings in the months ahead.

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