The Emergence of the Emerging Markets

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- The emerging markets have evolved in recent years to become an economic juggernaut and creditor to the developed world.
- Though investors accept additional risks when investing in the emerging markets, they should also benefit from the emerging markets' superior return potential, as well as diversification benefits.

The emerging markets have dramatically improved their position within the global economy from numerous perspectives. Many countries have enhanced their circumstances to such an extent that they could be considered to have emerged from their previous less developed status. This month we review how the emerging markets are defined, the extent to which their place in the world economy has evolved, and the investment opportunities that are available.

Emerging Markets Defined

The emerging markets are those countries with economies that are considered to be still developing and have not yet reached a more mature phase of growth. These nations are proceeding through the industrialization process and expanding the ranks of their middle class as incomes improve. Typically, most areas of the former Eastern Europe, Russia, the Middle East, Asia (excluding Japan), Central and South America, and Africa are considered to be emerging markets, though the most underdeveloped of such regions have been labeled “frontier” markets, such as Kazakhstan, Vietnam, and Nigeria. According to the World Bank, China, India, Indonesia, Brazil, and Russia are the largest emerging markets.

The Evolution of the Emerging Markets

Previously, the emerging markets were the bastion for politically unstable and heavily debt-laden nations, but many have transformed themselves over the past 10 – 20 years. In fact, emerging market economies are now the fastest growing in the world, outpacing the world’s developed leaders, the U.S., Europe, and Japan. Trade balances have shifted, transforming the emerging markets from net exporters of historically commodity-based goods to net importers of goods needed to drive their industrialization and emergence of middle class consumers.

The relative economic growth experienced by the emerging markets has increased their proportional share to more than one-third of the world’s gross domestic product (GDP). At the same time as their economic fortunes have improved, so too have their balance sheets. The world’s engine of growth is now also the creditor to the economically mature, increasingly debt-laden U.S. and Europe. China is now the largest foreign holder of U.S. Treasury securities.

In the graph on the next page from J.P. Morgan Asset Management, the economic growth and debt levels of some notable developed nations are plotted with the emerging markets (EM). The countries with the greatest economic growth lie toward the top of the chart, while those with the least amount of debt relative to their GDP are to the left. The emerging markets possess both preferred qualities—faster-paced growth and lower government debt. The size of the circles in the graph indicates the yield on each country’s 10-year government bonds. Despite the emerging markets’ better growth and lower debt, their government bonds yield as much as the bonds of developed nations that have had, or are undergoing, meaningful financial hardship, such as Italy, Spain, Ireland, and Portugal.

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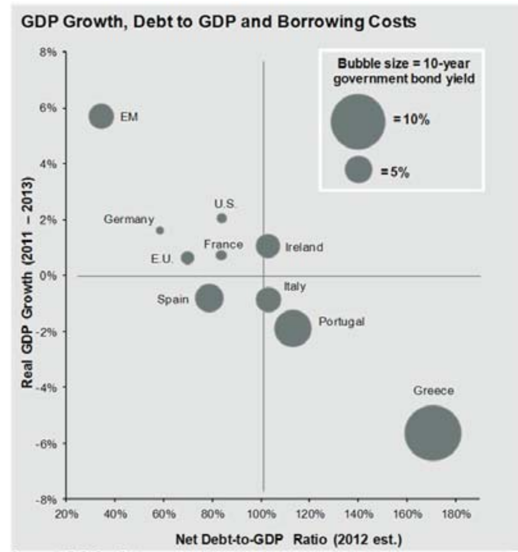

Source: IMF, BLS, J.P. Morgan Asset Management
Growth and debt data based on the October 2012 World Economic Outlook. Bond yields as of 12/31/12.
Data are as of 12/31/12.

Investment Opportunities

Despite the emerging markets' successes, their capital markets are still considered to be riskier than markets in the developed world. Though some emerging markets have less stable political infrastructures and less liquid capital markets, they also offer potentially greater opportunity.

As indicated above, emerging market sovereign and corporate bonds present one avenue for investment. The credit rating for the sovereign debt of many emerging market nations has reached the investment-grade tier, reflecting their improved circumstances and strong financial position. However, due to their overall higher risk profile, emerging market bonds offer superior yields versus comparably rated debt in the developed world as outlined previously. Emerging market debt is issued in either U.S. dollar-denominated or local currency form. Investors who believe that the superior economic growth of the emerging markets and their fiscal discipline will persist can select bonds denominated in the countries' local currencies in order to benefit from their potential appreciation relative to the U.S. dollar.

The emerging markets' superior economic growth should lead to better underlying earnings growth of companies operating in their jurisdictions and, consequently, better relative stock appreciation than in developed markets. Emerging market stocks are also generally more attractively priced than in the developed world, which supports the potential for future appreciation. The expanded opportunity set also provides the risk-reducing benefits of diversification through less correlated returns.

Though COMPASS constructs investment portfolios based on the needs of each client, most client portfolios have representation of both emerging market stocks and bonds. Clients can expect to benefit from the expanded opportunity set offered by such investments, as well as higher potential returns.