

Buttonwood

Out of fashion

Investors have become pessimistic about emerging markets



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LIKE hemlines and hairstyles, emerging markets swing in and out of fashion. A burst of enthusiasm in the late 1980s was followed by the financial crises of the late 1990s. In the first decade of the 21st century, they were all the rage again, and the term BRIC (for Brazil, Russia, India and China) was coined. When the economies of the rich world swooned in 2008, emerging markets seemed to be the best hope for the future.

But the past few years have seen their popularity wane once more (see chart). The change in mood is understandable. The IMF has forecast that 2015 will be the fifth successive year in which economic growth in emerging markets has slowed. Two of the BRICs—Brazil and Russia—are in recession. Many are uncertain whether the

Chinese authorities can engineer a soft landing for their economy, as it slows from the furious growth of previous decades. Emerging markets' advantage over rich countries, in terms of a faster growth rate, will be the smallest this year since 2001, according to IMF forecasts.

It is easier these days to find pessimists than optimists. Andrew Haldane, the Bank of England's chief economist, sees emerging markets becoming the "third wave" of the series of crises that began in 2007-08 with American subprime mortgages and continued through 2010-12 in the euro zone. The third-wave theme was echoed in a recent research note by Goldman Sachs.

The underlying problem is that a slowdown in emerging-market growth has been accompanied by a build-up of corporate debt. Excluding financials, emerging-market companies have an average debt level of 90% of GDP, according to HSBC; in Asia, non-financial corporate debt has jumped from 80% of GDP in 2009 to 125% today. Slower growth will make it more difficult to repay that debt; declining currencies will make it more difficult to repay the portion of that debt (just under a third, according to HSBC) that is denominated in dollars. According to a poll of fund managers conducted by Bank of America Merrill Lynch, investors think the two biggest risks to the world economy are a Chinese recession and an emerging-market debt crisis.

Corporate profits have not been growing as quickly as many investors may have hoped. Goldman Sachs calculates that Asian companies have not managed double-digit growth in earnings per share since 2010. John-Paul Smith of Ecstrat says that, more generally, the return on equity at emerging-market firms has fallen by more than seven percentage points since the financial crisis.

Mr Smith worries that a vicious circle is starting to develop, "whereby poor governance and policymaking, currency depreciation and downward pressure on living standards are beginning to behave in a reflexive manner." Sluggish growth will encourage governments to intervene more in the economy, imposing higher taxes or price controls. Governments may also deflect criticism by blaming foreign speculators or



companies for their problems.

Nationalistic rhetoric, in turn, will weaken investor confidence, reduce foreign direct investment and provoke capital flight. The effect, Mr Smith says, will “put further downward pressure on the currency and hence household living standards and encourage more populist policymaking.”

Some of this pessimism has clearly filtered through to investors. In the Merrill Lynch poll, the share of fund managers whose exposure to emerging-market equities was lower than normal exceeded those with an unusually high allocation by 28 percentage points. Capital Economics reckons that more than \$260 billion flowed out of emerging markets in the third quarter of the year. In nominal terms, this was even bigger than the outflow during the 2008-09 crisis. (As a proportion of emerging-market GDP, it was smaller: 4% versus 6% in 2008.)

When financial assets have been underperforming and investors are heading for the exits, contrarians naturally start to wonder whether it is a good moment to fill their boots. Emerging markets usually trade at a lower valuation than their rich-world counterparts, although there are moments when they are sufficiently fashionable to trade at a premium to rich-country shares (see light-blue line on chart). On this basis, they were most in vogue in the autumn of 2010, but are now trading at a discount again.

But that discount is not as big now as it was in the late 1990s. Until bargain-hunters see some sign of an improvement in the economic fundamentals, they will be forgiven for sitting on their hands.

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