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## Rise of the emerging market superpower

### Talking Head

BRYAN COLLINGS

While economic trauma continues in the developed economies, the US decision to buy mortgage-related assets represents a significant event, but one that on its own cannot and will not stop the current crisis.

Given that the prevailing levels of leverage in developed economies can no longer be sustained, corrective action requires treating the real causes (lack of savings), rather than merely the consequences (illiquidity). Relatively speaking, the emerging market economies have been resilient, despite the exogenous impact on their equity markets. The ongoing and secular strength of emerging market economies relative to developed economies is a trend I have observed for some time and one I think will become more pronounced. While convinced global equity markets will not uncouple significantly, given the fluidity of international capital flows, I believe the relative strength of emerging market economies during this turbulent period will only accelerate the inevitable creation of a new world economic order.

The unwinding of leverage and the associated lack of confidence is a headwind for global markets generally, and

while the very short term direction of the equity markets and outlook for the US dollar remains opaque, my conviction on emerging markets remains strong and well supported.

Emerging markets are now the largest economic bloc and provide a stimulus to the global economy. Prior to recent events, emerging markets economies were expected to deliver more than 60 per cent of all global growth in 2008 with the funding of this growth not dependent on foreign sources of capital. While the figures may have changed, the fact remains that emerging markets are funding the developed world.

Merger and acquisition activity involving emerging companies - as acquirers of developed markets' targets - has been rising steadily over the years with China and India forging ahead.

Key large emerging markets such as Brazil, India, Mexico and Russia have all moved from being net external debtors to net external creditors over the last few years and as things return to normal I expect this will continue. The corporate balance sheets of emerging markets companies have strengthened in line with sovereign balances, while leverage among non-financial companies is nearly half that of their developed peers and is at its lowest levels since 1998.

Although no one denies the

importance of the US in the global trade context, the trend has clearly been in favour of emerging markets. Emerging countries are trading more with each other and less with the US as demand in emerging economies booms. Intra-emerging markets exports have risen significantly since 2000, while exports to the US have decreased.

### Emerging countries are trading more with each other and less with the US as demand booms

The theme of infrastructure spending in emerging markets is not new and many investors have been exploring this opportunity for several years. But statistics show this is just the beginning of a long road that will see over \$20,000bn in emerging markets infrastructure spending during the next decade. By 2015, almost half the population of emerging markets (nearly three quarters of the world's urban population) will live in urban areas, thus accelerating demand for power generation, transportation, and sanitation.

This may slow in the current credit environment but will ultimately come through.

These positive developments have been reflected in the strong performance of emerging markets from 1998. However, the growth will continue and valuations are even more compelling than they were just a few weeks ago.

Commodity spot prices are undergoing a justifiable and short term pull-back, but the extent of the correction is excessive. Equities have fared worse and are approaching distressed levels.

The oft-raised issue of risk as measured by standard deviation is manifestly a misconception of risk. It is true that standard deviation of returns in emerging markets is much higher than that of, say, the S&P index, but the volatility in emerging markets is just a reflection of lower liquidity and market perception of historic risk - and not of higher relative fundamental risk.

With single digit debt/equity ratios and double digit cash flow yields, emerging markets companies are a steal when global volatility causes their stock prices to fall in value.

The real risk for investors is missing the boat for another 10 years, as many have over the last decade. From a fundamental perspective emerging markets will outperform from current levels over the long term, therefore a buy and hold strategy will reap benefits.

*Bryan Collings is managing partner at Hexam Capital Partners*