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MARKET COMMENTARY

Ashmore

Emerging Markets – Powerhouse of global growth

By David Muller

Emerging Markets (EM) today are the world's primary drivers of global growth and wealth accumulation. They cover a dominant share of the world's population and natural resources, and are called home by the world's largest reservoir of future consumers.

Despite these incredibly attractive features, investors' perception of these markets has not changed much over the last two decades; many miss the forest of opportunity for the tree of perceived risk.

This gap between dated perceptions and today's reality leads to a structural mis-pricing of Emerging Markets assets and can provide investors with attractive investment opportunities.

What are Emerging Markets?

Of the nearly 200 countries in the world, more than 160, or 80%, are classified as 'emerging'. The primary tool for such classification is a measurement of wealth, most frequently expressed as Gross Domestic Product (GDP) per capita. The International Monetary Fund maintains a useful list of Emerging and Developing Economies[1] while the World Bank references those countries that may be considered low-income, lower-middle income or upper-middle income.[2] But how useful are these static definitions? They give little acknowledgement to the dynamism of Emerging Market economies, nor to the pace with which these economies develop and differentiate themselves, moving them further away from the image of decades past.

Classic definitions of Emerging Markets focus largely on data that only partially reflects the dynamism and rapid development of this large universe of countries

In addition to the level of wealth as a determinant of what defines an Emerging Market, the second key factor is the degree of development of the financial markets in these countries. It is not always the case that GDP per capita, the standard measurement of wealth, goes hand-in-hand with financial depth or sophistication. A number of countries with high GDP per capita but relatively underdeveloped financial markets are frequently classified as Emerging Markets, including several of the oil-based Middle Eastern countries. The focus on financial development is critical, as the evolution of markets (including financial institutions and instruments) correlates highly with the level of economic development.

In sum, the countries that fall into the Emerging Markets category are in a transition phase, both economic and structural, as their financial and regulatory systems mature.

The level of financial development is rapidly increasing as global investors move global capital into Emerging Markets

A powerhouse emerges

Urbanisation is a key driver of economic development. By any measure, the Emerging Markets have experienced dramatic and exponential growth in their urban population over the past three decades. As shown in Figure 1, of the twenty largest cities in the world, sixteen are located in Emerging Markets.[3]

Fig 1: **Expanded urbanisation of Emerging Markets**

Ranking	City	Population (million)	Population Density (per sq km)
2	Jakarta, Indonesia	30.5	9,500
3	Delhi, India	24.9	12,100
4	Manila, Philippines	24.1	15,300
5	Seoul-Incheon, South Korea	23.5	10,400
6	Shanghai, China	23.4	6,100
7	Karachi, Pakistan	22.1	23,400
8	Beijing, China	21.0	5,500
10	Guangzhou/Foshan, China	20.5	6,000
11	Sao Paolo, Brazil	20.3	7,500
12	Mexico City, Mexico	19.4	8,400
13	Mumbai, India	17.7	32,400
15	Moscow, Russia	16.1	3,500
16	Dhaka, Bangladesh	15.7	43,500
17	Cairo, Egypt	15.6	8,900
19	Bangkok, Thailand	14.9	5,800
20	Kolkota, India	14.6	12,200

Source: Demographia's World Urban Areas Index, 2015.

[1] The main criteria used for classification are (1) per capita income level, (2) export diversification, and (3) degree of integration into the global financial system.

[2] For 2018, low-income countries are those with GNI (gross net income) per capita of $1,005 or less in 2016; lower middle-income economies are those with GNI per capita between $1,005 and $3,955; upper middle-income economies are those with GNI per capita between $3,956 and $12,235.

[3] Demographia's World Urban Areas Index, 2015.

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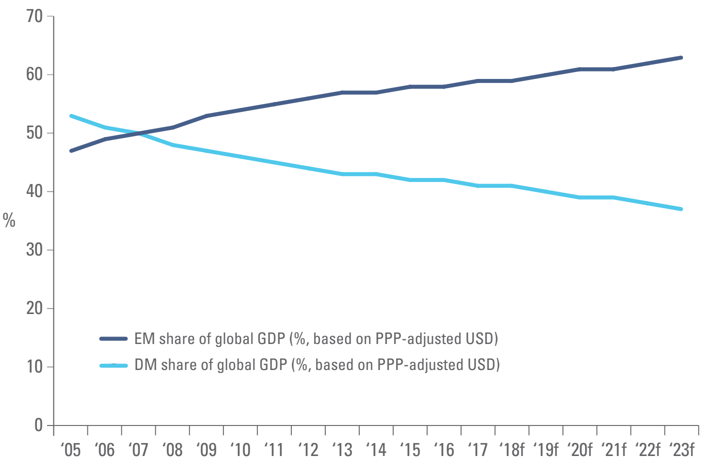
Nothing typifies the rapid pace of urban growth in EM more than the transformation of Shanghai, China, shown below in 1990 (left) and 2015 (right). What has occurred in Shanghai is the rule, rather than the exception, in EM countries around the world.

In total, 6 billion people or approximately 85% of the world's population lives in an Emerging Market country.[4] By any measure, the population in EM is significantly younger than that of the developed markets. Major strides have been made in terms of life expectancy, education levels, infant mortality and other key metrics of development. Expectations of quality of life have risen as well, driven by domestic economic dynamism as well as the knowledge obtained through global communication and access to technology.

Emerging Markets have become a powerhouse of the global economy. As shown in Figure 2, EM countries today represent 59% of total global GDP (based on PPP-adjusted USD), a notable expansion over the past decade, when these countries represented less than 50% of global GDP.

Fig 2: **Share of global GDP**

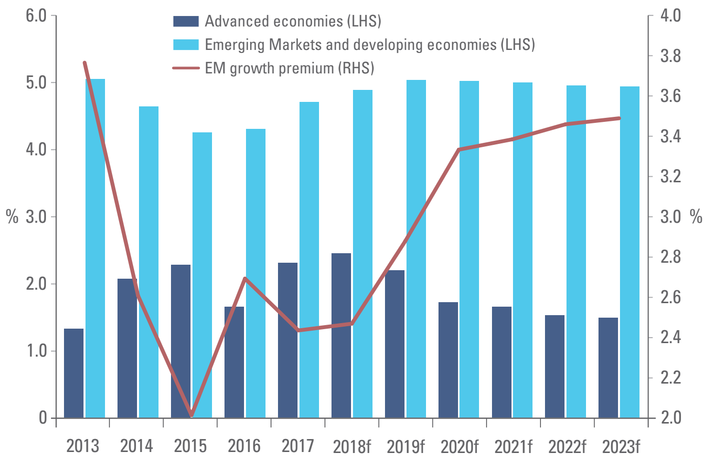


Source: Ashmore, IMF.

A simple look at the current levels of GDP, however, tells only a part of the story. Based on current economic growth forecasts prepared by the IMF,[5] EM GDPs will continue to grow notably faster than those in developed markets (DM) economies until at least 2023 as shown in Figure 3. The 'growth premium', i.e. the difference between EM and DM growth rates, is forecast to increase from 2.4% in 2017 to 3.5% in 2023. The growth premium reflects an increased rate of growth in Latin America, the Middle East and Sub-Saharan Africa, and a stagnant rate of growth in DM.

This rapid pace of economic growth provides multiple opportunities for those companies that can respond effectively to the resultant increase in consumer demand.

Fig 3: **Emerging Markets growth premium (as at April 2018)**



Source: Ashmore, IMF.

What doesn't kill EM...

In the wake of the 2008/2009 global financial crisis, DM central banks and governments introduced quantitative easing (QE) policies to stimulate domestic growth as interest rates were swiftly managed downwards. The impact on EM economies was significant and long-lasting, most notably on exchange rates. QE represented a major distortion of asset price valuations, as it largely severed the intrinsic link between traditional market drivers such as interest rates, and asset prices. With global investors rushing to buy dollars to invest in assets being purchased by the Fed, and subsequently Euro-denominated assets being purchased by the European Central Bank, they sold a sizeable portion of their existing EM investments, contributing to a depreciation of EM currencies of up to 45%.

This pivotal event ultimately served to boost the competitiveness of EM currencies, triggering a gradual and sustained improvement in these countries' external balances. Current accounts, which had previously been in deficit, reflected the improvement in exports, and as deficits shrank or turned into outright surpluses,

[4] Speech by Christine Lagarde, Managing Director, IMF at University of Maryland, February 4, 2016.
[5] IMF World Economic Outlook, April 2018.

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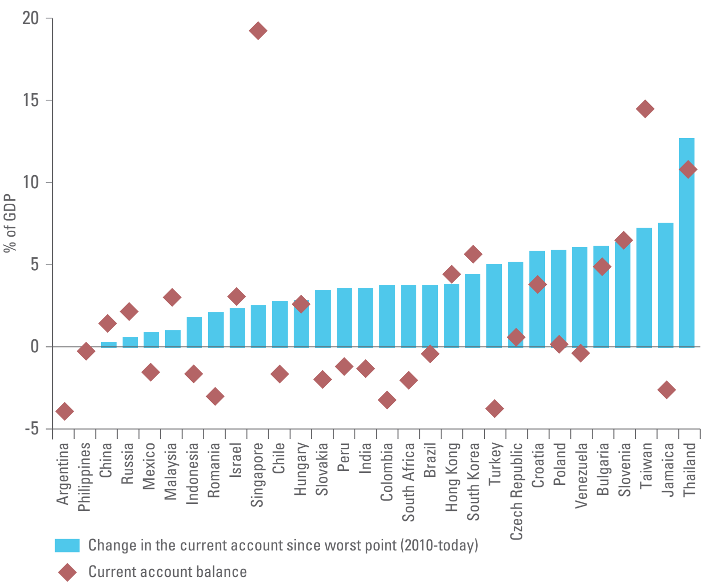
the need to finance these deficits diminished, benefiting these countries' capital accounts. The end result has been a dramatic amelioration of prior fiscal imbalances. Figure 4 highlights the significant improvement in current account positioning post-QE and the current level of deficit or surplus.

Fig 4: **Current account as % of GDP**



Source: Bloomberg, Ashmore. Data as at 2 March 2018.
'Worst Point' is defined as the lowest current account balance point between 2010 and year-end 2017.

In addition to their contribution to the global economy, EM countries have accumulated significant wealth. As shown in Figure 5, these countries now control 76% of global foreign exchange reserves. This accumulated wealth provides an important buffer against unanticipated global risk events as well as flexibility in the event of currency volatility.

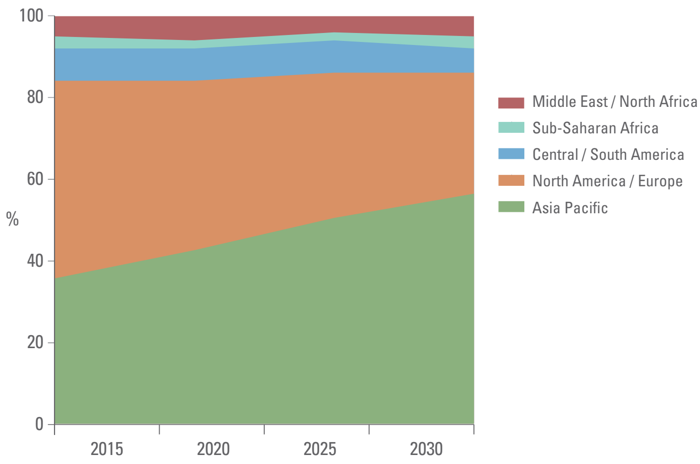
Fig 5: **Foreign exchange reserves**

Region	Reserves (USD bn)	% of global reserves
World	11,457	100%
Emerging Markets	8,726	76%
Developed Economies	2,731	24%

Source: Ashmore, IMF, data as at 31 January 2018. Estimates by Ashmore.

This wealth accumulation is the result of sustained and increased economic growth, an expansion of the 'middle class' benefiting from increased wages, government efforts to address income inequality and the development of a concept of savings and investment. With increased wealth comes increased consumer spending, further stoking demand for consumer products, improved housing, and the other discretionary items demanded by an upwardly-mobile middle class. As shown in Figure 6, the Organization of Economic Cooperation and Development (OECD) estimates that middle class spending in Emerging Markets will increase from 25% of global consumption in 2009 to nearly 70% by the year 2030, a mere 12 years away.[6] This occurs as the size of the middle class increases from 1.8 billion to 3.2 billion by 2020 and to 4.9 billion by 2030, with the bulk of the growth occurring in Asia.

Fig 6: **Middle class spending**

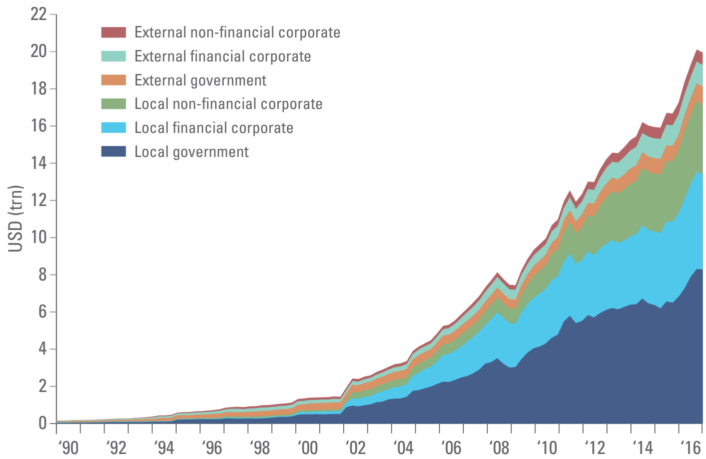


Source: OECD.

Deepening financial markets

It is important to recognise the rapid development of financial markets and the role that increased access to global capital markets has played in encouraging the efficient flow of capital. EM countries (as well as corporations) are increasingly able to obtain financing in both hard currencies, e.g. USD, EUR, and local currency, providing flexibility and an ability to search for the most cost-effective market in which to raise capital and permitting both governments and corporations a more efficient tool to balance revenues/income with expenditures/interest. Figure 7 highlights the dramatic increase in local currency bonds as an alternative to hard currency financing, with the 2008/2009 global financial crisis as the inflection point.

Fig 7: **The expansion of EM financial markets**



Source: Ashmore, BIS, IMF, Bloomberg.

An obvious discrepancy exists, however, between the contribution of EM to the global economy (see Figure 2 above) and its share of global capital markets. EM debt currently represents only 20% of the global fixed income universe, while developed markets represent the remaining 80%. This gap highlights the extent of underfinancing in EM (and over-financing in developed markets) and provides significant support to the statement that concern about over-indebtedness is exaggerated.

[6] OECD Development Center, Working Paper No. 285, *'The Emerging Middle Class in Developing Countries'*.

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Warning: Growth ahead

The heterogeneous universe of countries that fall into the Emerging Markets category have shown tremendous potential to expand their economies and to develop their financial markets, transforming them in the period of a few decades to the growth engine of the global economy. This rapid rate of growth has permitted the development of a sizeable upwardly-mobile middle class that demands not only access to increased goods and services, but also a suite of investment opportunities to assist in preservation and expansion of its growing wealth.

Citizens of EM countries now expect responsive and fiscally responsible governments; democratic electoral processes are now in place in the vast majority of these countries. Markets that had previously known hyper-inflation and rapid devaluation of their currencies have adopted much more centrist policies and have enabled governments to tackle the root causes of inflation, bringing down overall inflation rates and boosting the standard of living.

Two strong years of Emerging Markets fixed income performance should come as no surprise to investors who have been monitoring the steady improvement in economic fundamentals and socioeconomic trends in this universe of nearly 70 countries.

EM economies are now the powerhouse of the global economy, growing significantly faster than their DM counterparts, with inflation at low and manageable levels and with accumulated wealth, as reflected in the level of FX reserves and in the increased power of a rising middle class. With nearly two-thirds of global GDP now housed in EM, we believe investors should begin to structure their portfolios to reflect the current and future significance of these economies.

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