MV Capital Management Weekly Market Flash

What's Next for Emerging Markets?

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Asset markets have settled into a gentler pattern in recent days, erasing a sizable portion of the losses suffered during the first five or so weeks of the year. The rising tide has extended to that most battered of asset classes: emerging markets. This asset class has been the big underperformer among equities for more than a year now, ending 2013 with a loss even as the S&P 500 gained more than 30%.

With relative valuations so low, many market participants see a potentially attractive buying opportunity in the works. Our views are a bit more tempered: while we would not necessarily be surprised by a spurt of outperformance in the near term, we think the fundamentals argue for proceeding with caution.

Growing Pains

For the better part of the 21st century emerging markets have been the global economy's growth engines; in many years enjoying double-digit real GDP growth. Millions of Brazilians, Chinese, Indonesians and Indians ascended into a rapidly expanding middle class, bringing prosperity not only to local businesses but to S&P 500 titans as well. Many of the largest U.S. companies earn more than half their revenues and profits from their overseas activities. But recently, the growth trend has markedly slowed down. Brazil's real GDP growth in 2013 was a paltry 2.2%. Turkey, which as recently as 2011 was growing at a double digit clip, is looking at potentially sub-1% real growth this year. Even India, one of the strongest emerging markets, is languishing in mid-single digits.

Flight of the Creditors

Debt was always lurking under the surface during the heady growth years. Foreign creditors were more than happy to lend to emerging markets businesses and consumers, much of which was in hard currencies. As external debt rose on emerging corporate balance sheets, other troubling data points like inflation and swelling trade deficits appeared as well. In sharp contrast to the sub-2% inflation rates seen in most developed economies, price index gains are currently more than 6% in Brazil, Russia and India. A more extreme case is Turkey, where an inflation rate of 11% helped spark a credit market exodus that spread to South Africa, Russia, India and Brazil. As creditors fled, local currency rates plunged, making those debt-laden balance sheets even more onerous.

The China Question

Looming over the whole emerging markets debate is China. The world's second largest economy continues to grow: its 2013 GDP rate of 7.7% was the largest among the 42 major developed and emerging markets tracked weekly by the *Economist Intelligence Unit*. What concerns investors, though, is where most of the growth is coming from. China's leaders have committed to rebalancing the economy away from investment (much of which is speculative rather than productive in nature) in favor of more domestic consumption. Consumer spending accounts for just 35% of China's GDP, as compared to 70% in the U.S. But that rebalancing will be tricky, involving a cooling off of the country's overheated financial system as well as unpopular political decisions.

These are some of the key issues giving us pause in regard to emerging markets. We remain underweight in the asset class, and will remain so until we have more evidence of the case for growth. That evidence will need to include some indication that Xi Jinping and his economic policy team are successfully maneuvering their way through the China rebalancing challenge.

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