THE TURNING GLOBALIZATION CYCLE
Emerging Markets

MCS White Paper **October 2013**

Executive Summary

- Emerging Market Definition
- Rise in Importance
- Investment Strategy Implications
- Proper Entry and Exit Points for Investing

Introduction

While most investors know a few countries included in Emerging Markets, such as the popular BRICs - Brazil, Russia, India and China, they may not know much else about the category and its implications for investing. This paper will delve into how emerging markets are defined and which countries can be grouped together based on that definition. It will also discuss the rise in importance of emerging markets and the implications for investment going forward. Metropolitan Capital Strategies plans on investing in Emerging Markets (EM) numerous times in the next few years.

Emerging Market Definition

A nation with an emerging market economy is typically transitioning from an agricultural or early industrialized economy to a more highly developed, industrialized economy, although, it could have regressed from developed status. Most emerging economies have reasonable liquidity in their equity and debt markets enabling foreign investment. While these nations do have functioning markets, typically they are not as efficient or as tightly regulated as developed markets and thus may carry more risk for the investor. The tradeoff for that additional risk has typically been growth in excess of that which is attainable in developed economies. In addition to the economic characteristics mentioned above, many emerging market nations also include the following social characteristics: growing populations, high birth rates per capita, and demographics skewed younger than developed market countries.

According to Dr. Vladimir Kvint, president of the International Academy of Emerging Markets, "an emerging market country can be defined as a society transitioning from a dictatorship to a free market-oriented economy, with increasing economic freedom, gradual integration within the global marketplace, an expanding middle class, improving standards of living and social stability and tolerance, as well as an increase in cooperation with multilateral institutions."[1]

Working from those and similar definitions a number of organizations have developed lists or indices of countries they categorize as having emerging economies or markets. Not surprisingly, each group includes different countries and there is a significant difference in numbers of countries included. The broadest list came from the International Monetary Fund (IMF) and included 150 nations as of 2010, a number of which would also likely be categorized as Frontier Markets or Least Developed Countries (LDC). Other categorizations of Emerging Markets (with the number of included nations) are provided by the Dow Jones Emerging Market Index (17), FTSE Emerging Index (22), MSCI Emerging Market Index (22) – see the graphic to the right, and Standard & Poors Emerging BMI Index (20). In addition to these indices there are also sub-sets of the emerging markets such as the aforementioned BRICs and its numerous variants, Next Eleven, Global Growth Generators, Newly Industrialized Nations, and a host of others.

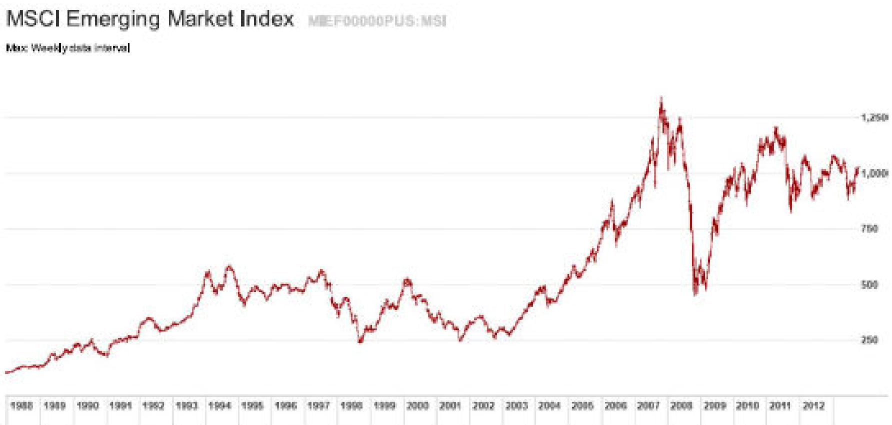
Source: MSCI, Inc. Global Equity Indices

Rise in Importance

Broad based investment in EM began in the late 1980s and early 1990s with the beginnings of the globalization movement. The strong growth of developed economies during that period provided increased demand for raw materials and manufactured components that were primarily supplied by the emerging economies for use/assembly in developed nations.

The increased trade and exposure to those markets began to introduce other goods and brands to the developed world. Automobile and electronic imports brought Kia, Hyundai, Samsung, and Lenovo to our attention at the end of the 20th century. At about the same time outsourcing became a big movement; all manner of jobs, from manufacturing to IT services, moved out of developed countries to emerging markets. The capital and new opportunities resulting from these shifts drove tremendous growth in those markets in the mid-00's up until the financial crisis.

The financial crisis in developed markets and the yield stifling monetary policies instituted in response drove significant capital into EM as investors searched for returns to rebuild lost wealth. Over the five years since the crisis developed economies have been slowly improving; while not "healthy" yet there are concerns, particularly in the US, that if the QE and Zero Interest Rate Policy are continued for too long they will cause unforeseen damage to the economy.



Source: Financial Times

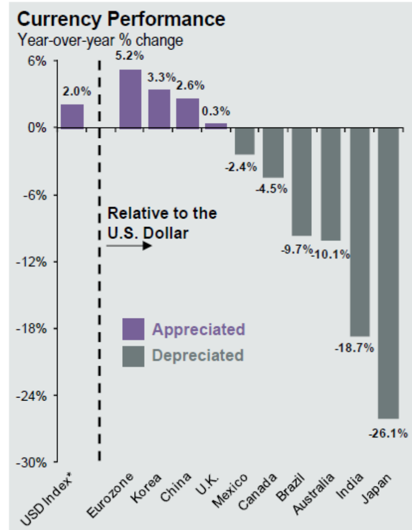
This improvement and the anticipation of the reduction in extraordinary measures employed by central banks post crisis has tempered EM performance for the near term. As the anticipated timing of a change in US monetary policy entered public knowledge this past summer, the EM began a selloff both in markets and currencies. Only when the US Federal Reserve announced that they would continue the $85B per month Quantitative Easing (QE) program in September did the trend of outflows and currency devaluation slow.

While all emerging economies have benefited from the globalization movement, perhaps none have more than China. It is the second largest economy in the world, approximately 10%-12% of global GDP, deserving of a special place within the group of emerging markets. It is the most powerful nation in the emerging market group and one of the most developed. As a member of the G-20, the countries with the 20 largest economies in the world, it and the other seven emerging market countries included in the body play a significant role in coordinating and trade, commerce, and economic issues worldwide.

In the early 2000s China's GDP was routinely growing at a double digit pace, far outstripping the performance of developed economies. The significant growth rate gap continues today even as China's growth has slowed to the 7%-8% range recently. As their economy slows from its peak growth, there is a growing emphasis on moving from an economy driven by exports toward increased domestic consumption. This structural shift coupled with a burgeoning middle class in the world's largest population will provide the consumers needed to accomplish the change and will make China a very compelling market for the foreseeable future.

Investment Strategy Implications

In the short term, continued improvement in developed economies and the prospects for better returns with lower risk will likely cause additional flight of capital and potential for further currency devaluation within a number of the EM constituents. Should the changes to the US Federal Reserve's QE program, expected to begin in late 2013 or early 2014, be more dramatic than expected, in either the amount of the reduction or the time frame over which the program will be curtailed, the potential for additional slowing and currency devaluation in emerging markets is likely. If those conditions were to develop they could present an opportunity for MCS to short the Emerging Market Index or a single country within the EM universe via an inverse ETF.



Source: JP Morgan, Inc. GTM 4Q 2013

Over a longer time horizon, purely from a demographics perspective, the emerging markets must become more influential; depending on which countries are included, they contain up to 80% of the world's population and account for one-third of world trade. Goldman Sachs forecasted in 2007 that the world's largest economies in 2050 will be China, USA, India, Brazil, and Mexico – four of the five are currently classified as emerging markets.

The large populations, mostly favorable age demographics, and increasing personal incomes within many of the EM countries are leading to an increasing target market for consumer goods. This growing market coupled with economic restructuring to expand domestic consumption has potential to fuel additional demand and growth in many of the EM countries.

As a region the emerging markets have provided numerous opportunities for investment over the past 30 years. Their continued growth and further integration into the world economy should provide many more opportunities for investment in the future.

While long term opportunities in emerging markets have great potential, they also present numerous risks. Currency/exchange rate, interest rate, liquidity, and political risks are a number of the risks that may impact investment in emerging markets. One of the tenets of MCS is to manage risk; our investment entry and exit into emerging markets would be at specific times for a short duration. The location of the particular emerging market within the business cycle and the correlation of the cycle to other markets will also impact the risk of investment. As with other regions or asset classes, in many cases the risks involved with the investment or the expected returns will not meet MCS's strict standards for investment. MCS will continually seek the opportune moment and perfect target to tactically employ our resources within the emerging markets for double digit gains with low risk. We continue to believe understanding pertinent data - and waiting for the right moment – is the key to investing success.

1. Forbes. "Define Emerging Markets Now" http://www.forbes.com/2008/01/28/kvint-developing-countries-oped-cx_kv_0129kvint.html
2. The N-11: More than an Acronym, Goldman Sachs Global Economic Paper No: 153 http://web.archive.org/web/20110719172009/http://www.chicagobooth.edu/alumni/clubs/pakistan/docs/next11dream-march%20'07-goldmansachs.pdf