

The Rationale for Investing in Emerging Markets

An Interview With David Hale

Article Highlights

- Emerging markets account for 36% of global GDP and are growing faster than the old industrial countries.
- When there isn't a global financial shock, diversification benefits increase from investing in emerging markets.
- Emerging market stocks now have about a 25% market capitalization weighting on a global basis.

David Hale is a macroeconomist and chairman of David Hale Global Economics, Inc. He spoke with me recently about why individual investors should consider emerging markets.

—Charles Rotblut, CFA

Charles Rotblut (CR): *What's the rationale for investing in emerging markets? Why should investors include securities from these countries in their portfolios?*

David Hale (DH): Emerging markets are a large and growing part of the world economy. They're significantly outperforming the old industrial countries. Their growth rates over the last four years have been around 6+%. The old industrial countries have a growth rate less than 2%. And this will continue indefinitely. Emerging markets now account for about 36% of global GDP [gross domestic product], but they account for half of global exports and half of global capital spending. They've also got \$7 trillion of foreign exchange reserves, compared to \$3 trillion in the old industrial countries.

China plays a big part in this. China is now the world's largest exporter of tradable goods. China's investment share of GDP is 48%. Most developing countries are somewhere between 25% and 35%. Most old industrial countries are between 15% and 16%. China also has \$3.3 trillion of foreign exchange reserves, so it is a big part of that story.

But the fact is that we've had high growth rates elsewhere in Asia. We have a 5.5% growth rate this year in Africa. We have very high growth rates in Latin America and Europe: 7% in Brazil, 5% to 6% in Chile, and 7% or 8% in Peru. So it's a growth story.



CR: *Is the growth priced into valuations, or do you think there's more upside?*

DH: The valuations are not bad. You can buy Latin American stocks at a price-earnings ratio of 11 to 12, and you can buy Asian stocks at a price-earnings ratio of 10 to 11. They're a bit below their long-term averages because we did have a correction of the emerging markets last year. We had a very good rally in 2010 and went to new highs. In 2011, many emerging

market countries had tighter monetary policies to fight inflation. So the market's corrected about 15% or 20%.

CR: *In terms of investing, should investors look only at stocks, or should they consider stocks and bonds?*

DH: There are bond markets now in many countries, not in all. And there is some offshore debt in these countries, which is dollar-denominated. So you have a choice of equities, selective debt and also, in some cases, what you call euro-bonds—dollar-denominated debt of the various countries.

CR: *Do you recommend that individuals invest directly in emerging markets? I know some of our members think they can get exposure to emerging markets by buying the U.S. multinationals.*

DH: You can get some exposure that way. But, basically, U.S. companies get about a third of their earnings overseas, and the great bulk of U.S. foreign direct investment is still in Europe, Canada, countries that have old established relationships. U.S. investment in emerging market countries is growing rapidly, but it doesn't dominate yet. It's not as big as

our investment in Europe; we've been in Europe for half a century. We've been investing in emerging markets only for the last five or 10 years.

CR: *Should investors be concerned with currency risk?*

DH: There is some currency risk, but it goes both ways. Many emerging markets have had currency rallies in the last two years. The Brazilian real went up 40% against the U.S. dollar in 2010 and 2011. Korean currency had a pretty good rally. So currency cuts both ways. You can often have currency gains. But sometimes monetary policy is too easy, and you can have currency losses.

CR: *Are the politics a concern? China, obviously, is ruled by an authoritarian regime, but what about markets like Brazil or India?*

DH: Politics are always an issue, because if you get the wrong leaders, you can get bad policy, and that can have an adverse effect on the market. Sometimes countries can also reach a political impasse, where they cannot enact any new reforms. That gets in the way of making decisions.

That's currently the situation in India. The Indian government did very badly in the state elections this past spring, so the government right now is finding it very hard to do anything. Brazil had a seamless transition a year ago from Lula da Silva to Dilma Rousseff, the new president, and so far she's been reasonably effective. She's cutting public spending, doing things the market wants to see happening.

Politics are always a concern, because if you get the wrong leader in a small country, they can do a lot of damage.

CR: *What about the maturity of the markets? The markets themselves are new.*

DH: These markets are in many cases 10 to 20 years old. We have a whole new category of market—not emerging markets, but frontier markets. These markets are in Africa, north of Johannesburg. They're in the Middle East. They're in South Asian countries like Bangladesh and Sri Lanka and

Kazakhstan.

There are a couple frontier markets in Latin America: Argentina's been demoted from being an emerging market to being a frontier market because it's had a lot of very bad policies for business and things like that. The frontier markets are often relatively new—in the last 10 to 15 years. But Buenos Aires has had a stock market for over a hundred years. Argentina has generally had a long, unhappy history of bad policies for business—a lot of populism, that kind of thing.

CR: *I know a lot of mutual funds are heavily weighted in Petrobras (PBR), China Mobile (CHL), the major companies. How do investors get diversification in the emerging markets?*

DH: That's where the market caps are big—tens of billions of dollars. But there are a lot of companies with smaller market caps that can also be attractive. I would say the emerging market middle-cap category has lots of very interesting companies in a whole range of sectors.

CR: *So investors should look for a mutual fund that targets those?*

DH: They can also now buy exchange-traded funds (ETFs). We have ETFs for many countries. We have ETFs for Malaysia or India or South Africa—for a whole range of countries. You could buy a mutual fund. There are now dozens of mutual funds that invest in emerging market countries or invest in global portfolios in general. So there are different ways you could do it. There are hedge funds available that only invest in emerging markets; they don't do big G8 countries, they only do emerging markets.

CR: *Given that correlations ebb and flow with the markets, are emerging markets now becoming more closely correlated to U.S. markets?*

DH: Because of the nature of the shocks we've had over the last five years, the very major global financial crisis of 2008 and 2009 had a devastating effect on markets all over the world. So you could not hide in emerging markets.

They were dragged down along with the old industrial countries.

But when you don't have major financial shocks, you could have a decorrelation occur. Last year, emerging markets underperformed the U.S. and Europe, as they had all this monetary tightening. This year, they're easing monetary policy. So they had a very good first quarter, up 12%. It varies depending on the circumstances.

I think the odds of a global financial crisis like we had four years ago are now pretty low. We learned from that experience, policy is ready to deal with it, so I don't think we're going to have as high of a correlation over the next two or three years as we had in 2008.

CR: *So you think, going forward, you'll still get more diversification benefits by keeping the exposure to emerging markets?*

DH: Yes, I do think that. I think the diversification benefits could increase. Unless we get a repeat of what happened in 2008 when Lehmann Brothers failed and we had a global credit squeeze.

CR: *If an investor is going to add emerging markets to the stock portion of their portfolio, any suggestions on how much they should allocate?*

DH: Emerging markets now have about a 25% market weight in the global investment universe. So if you want to match the emerging market share of global stock market capitalization, it would be 25%. If you're cautious, you can go for 10% to 15%. If you're aggressive, because you like the story, you could go for 30% to 40%. If all you're doing is passive investing, it would be 25%.

CR: *And do you think that holds even for someone who's retired?*

DH: I think the emerging markets will outperform the old industrial countries looking out five or 10 years, so I would tend to overweight emerging markets, not underweight them.

CR: *Any suggestion for a bond allocation?*

DH: Bonds are different. Again, there isn't a bond market in every country. There are bond markets in South

Africa, there are bond markets in Brazil, there's not much of a bond market in Peru. So it varies by country.

CR: *What about commodity risk? I know South Africa and Brazil are very dependent on commodities.*

DH: You get a lot of commodity exposure in some developing countries. It's very high in Chile (copper), Peru (copper, gold, silver), Brazil (iron ore and soy beans), and Indonesia (coal, also some iron ore, some oil). So, several emerging markets have significant commodity exposure.

The two biggest market-cap stocks in Brazil are commodity stocks: Petrobras (PBR) for oil and Vale (VALE) for iron ore mining. It's iron ore mining now all around the world. I also bought International Nickel in Canada three years ago. So you have nickel as well as iron. But it's very much a commodity play.

CR: *Is there something I haven't asked you that individual investors should think about regarding emerging markets?*

DH: It's like any market. The challenge is to get good research on

companies, to know what's happening in the companies, to be well-informed. If you do have good research and you are well informed, then I think you have many opportunities to outperform the global indexes. Again, that's looking out five or 10 years. But I put a heavy emphasis on seeing the companies. Whenever I go to emerging market countries like Singapore, Malaysia, or China, I always try to visit companies. I like the grassroots feel of seeing what companies are saying. And I find it has been helpful in making money in those countries over the years.

CR: *Regarding China, we had a problem last year with some of these companies being listed with the reverse mergers (the acquisition of a public company by a private corporation).*

DH: We had several reverse mergers with NASDAQ. There were a lot of frauds and a lot of scandals. That's a reminder that China is far from perfect. And you had companies filing different kinds of reports with the government than they did with the shareholders. There was research done by some hedge funds that found these problems and

exposed them. It caused major share price crashes. We saw that last summer with Sino-Forest—market cap of \$6 billion and now it's bankrupt. That was very much driven by a hedge fund doing the research, finding contradictions, and publicizing them. They made lots of money being short that stock.

CR: *You would suggest when looking at emerging markets that investors should think long term?*

DH: I do think the emerging market story is a five- or 10-year story. But there are some cycles when you can outperform or underperform based on various shocks, like rising interest rates, maybe political instability. So you must be sensitive to those shocks, and if they're bad enough, then get out of the way.

But I don't think the kind of events we had in 2008 will happen again for some time. That was truly a global financial crisis. And it sucked everything into it. The emerging market stock capitalization fell from over \$14 trillion down to \$6 trillion or \$7 trillion. It was a very devastating hit. ▲

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