

Economic Outlook

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The Push and the Pull into Emerging Markets

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- Quantitative easing (QE) “pushes” investors into the higher yielding assets of emerging market economies (EMEs).
- EMEs superior growth profiles also “pulls” capital from developed markets.
- The “push” factors should subside in the medium-term as QE ends and developed economy interest rates eventually normalize.
- The “pull” should continue well into the future, as EMEs currently account for 50% of global GDP but only 19% of the global market capitalization of listed stocks.
- Declines in EME asset prices present an opportunity for longer-term investors to diversify into EMEs at more attractive prices

Over the past several years, investors in developed economies have been both “pushed” and “pulled” into emerging markets.¹ The “push” has come from G-4 central banks,² which have kept short-term interest rates near zero and used balance sheet policies to suppress longer-term interest rates. Investors have responded by diversifying into riskier asset classes, including emerging market debt and equity. The “pull” has come from the improving relative economic profile of the emerging market economies (EMEs) themselves. Emerging and developing economies now account for more than 50% of global GDP and 70% of global GDP *growth*, up sharply from just 39% of global GDP and 56% of global growth ten years ago.³

The “push” into emerging markets is a cyclical phenomenon likely to diminish over the next few years. Eventually, G-4 monetary policy will normalize, likely beginning with the “tapering” of the Fed’s asset purchase program next year. As dollar-denominated yields and expected returns increase, foreign portfolio flows into emerging markets will naturally diminish and could reverse. The mere possibility of tapering led to significant pullbacks in fund inflows and increases in interest rates in the middle of 2013.

Conversely, the “pull” from EMEs is a secular phenomenon set to persist well into the future. Financial assets are claims on economic activity. As the EME share of global output increases, so too must the EME share of financial assets held in global investors’ portfolios. The problem is that financial markets and legal institutions in these economies have not developed at a pace commensurate with the increase in GDP. The market capitalization of domestic businesses in EMEs is equal to just 19% of the global total for listed equity, less than two-fifths of EMEs’ share of global GDP. Longer-term investors should treat any decline in EME asset prices associated with tapering as an opportunity to diversify into EMEs at more attractive prices, while also developing strategies to increase claims on private, unlisted businesses that account for the bulk of economic activity in EMEs.

¹ Fratzscher, M. (2011), “Capital Flows, Push versus Pull Factors, and the Global Financial Crisis,” ECB Working Paper No. 1364.

² The G-4 refers to the Federal Reserve, Bank of England, Bank of Japan, and European Central Bank.

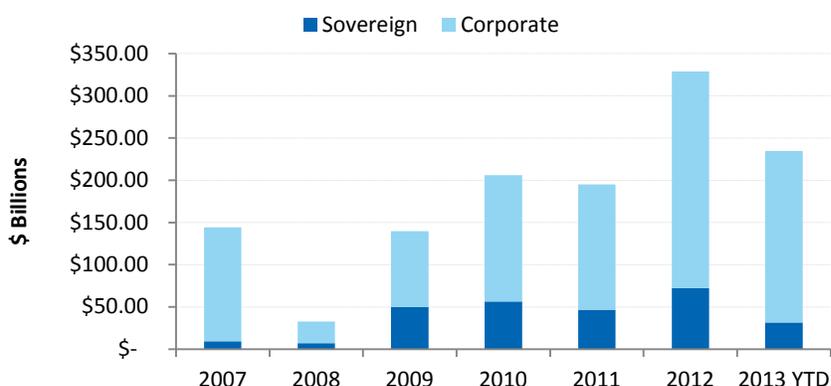
³ IMF, 2013 World Economic Outlook Database.

Inflows into Emerging Markets

Between 2008 and 2012, annual net portfolio flows into emerging markets increased by \$300 billion.⁴ By 2012, the three-year cumulative net portfolio flow reached 2% of emerging markets' GDP, the largest increase since the years immediately preceding the 1997-1998 emerging market crises. Although the size and composition of the inflows differed substantially by country, fixed income investment accounted for the bulk of the increase, in aggregate. Between 2009 and 2013, advanced economies' holdings of EME bonds increased by \$1.2 trillion, an investment pace nearly \$500 billion greater than the pre-crisis trend. Major bond funds' allocations to emerging markets increased six-fold, from 2% of assets under management (AUM) before the crisis to over 12% in late-2011.⁵

Fund inflows had a dramatic impact on pricing and issuance. Every 1 percentage point increase in net bond inflows (relative to GDP) has been associated with a 0.37% decline in 10-year government bond yields. Governments and businesses responded by issuing more debt and lengthening the maturity profile of their liabilities. Combined EME sovereign and corporate debt issuance reached \$330 billion in 2012, 2.3x the \$144 billion issued in 2007. The effective duration of outstanding EME sovereign bonds increased by 24% to 7 years, while the effective duration of EME corporate bonds increased 23% to 5.2 years. The increased demand for EM debt also allowed first-time issuers in "frontier markets" in Africa, Asia, Eastern Europe and Latin America to raise \$9 billion since 2009.⁶

Figure 1: Net New Issuance of Emerging Market Bonds⁷



Scale of Fund Flows Trigger Concerns about Fragility

The scale of recent portfolio inflows and their concentration in fixed income securities led many analysts to voice concern that by pushing investors to EME debt, Fed policy would eventually trigger a crisis.⁸ EME crises tend to follow a familiar pattern: Large net portfolio flows relax credit constraints facing businesses and households, increase asset prices, and stimulate borrowing and spending, which boost tax receipts. The positive impact of the capital flows are then cited as evidence of improving "fundamentals," which often leads to additional capital flows that further increase borrowing and expenditures. Eventually an exogenous shock or overextension of domestic borrowers' balance sheets causes net flows to reverse, which often triggers sharp and sudden declines in asset prices, credit growth, and aggregate expenditures.⁹

⁴ IMF, 2013 WEO Database. October 2013.

⁵ IMF, 2013 GFSR.

⁶ Carlyle Analysis of data in IMF 2013 GFSR.

⁷ IMF, 2013 GFSR.

⁸ Chen, et al. (2011), "International Spillovers of Central Bank Balance Sheet Policies," Bank for International Settlements.

⁹ Mendoza, E. (2010), "Sudden Stops, Financial Crises, and Leverage," *American Economic Review*.

There is little doubt that Fed policy contributed meaningfully to portfolio flows into EME debt over the past several years. As Bernanke explains, QE is designed to change the supply of investible assets in ways that force investors to diversify into riskier portfolios.¹⁰ Part of this rebalancing inevitably includes higher-yielding EME debt. Recent research suggests that bond issuance in emerging markets since 2009 would have been 50% of the actual volume in the absence of quantitative easing.¹¹ Thus, it should come as no surprise that EME asset prices would be especially sensitive to the “tapering” discussion that began in May 2013.

Between the middle of May and June 24 of this year, emerging market stocks fell by an average of 15%, bonds fell by 13%, on average, and a well-diversified basket of emerging market currencies fell by 6% relative to the U.S. dollar.¹² Interestingly, the magnitude of these price declines appears tied to the changing nature of cross-border intermediation. Since 2007, bond dealers’ inventories have fallen by two-thirds and daily trading volume is down by 20%, despite a much larger stock of outstanding bonds.¹³ The decline in bond dealer liquidity has allowed for much larger price moves than would be the case if their inventories could temporarily cushion supply-demand imbalances. For example, in the six weeks following the Lehman bankruptcy, the AUM of emerging markets bond funds fell by 22% but average spreads on emerging market debt increased by just 12 basis points. By contrast, in the six weeks following Bernanke’s May 22 testimony, the 6.3% decline in the AUM of emerging markets bond funds triggered a 76 basis point increase in EME spreads, a response 25-times greater than in 2008.¹⁴

The “Relief Rally” and Current Outlook

With dealer inventories unable to absorb the initial shock, asset prices likely overshot to the downside in the initial weeks following Bernanke’s May 22 testimony. However, the inevitable upswing was clearly aided significantly by the Fed’s decision to postpone tapering. Since the end of August, EME assets have enjoyed a “relief” rally: EM debt is up by 7.6%, EM equities have increased by 12%, and EME currencies have added 4%, on average.¹⁵ While many observers anticipate that EME assets will give back these gains (and more) whenever tapering actually commences, EMEs collectively appear better able to absorb the impact of price declines than in previous episodes.

First, external debt is a lot smaller relative to emerging markets’ repayment capacity. Since 1999, external debt has fallen from 41% to 25% of EMEs’ GDP. Measured relative to exports, the improvement has been even greater: external debt has fallen from 240% of exports in 1986 to just 77% in 2013.¹⁶ While individual countries may experience funding difficulties in the years ahead, emerging market economies hardly look overburdened by external debt flows on a collective basis.

Second, EMEs’ external borrowing has been increasingly denominated in their domestic currency. Ten years ago, virtually all of EMEs’ external debt was denominated in dollars or another “hard” currency like the euro.¹⁷ Foreign portfolio inflows into fixed income markets generated exchange rate risk and required EME central banks to maintain sufficient foreign exchange reserves to guard against outflows. The bulk of recent external borrowing has been denominated in local currencies, which has allowed EME governments to

¹⁰ Bernanke, B. (2012), “Monetary Policy since the Onset of the Crisis,” FRBKC Symposium.

¹¹ Lo Duca, et al. “The 2009-2013 Corporate Bond Issuance Global Frenzy: what role for US Quantitative Easing?” *Bank of Spain*.

¹² MSCI Emerging Market Stock Index, MSCI Emerging Market Currency Index, and the J.P. Morgan Emerging Market Bond Index (Plus).

¹³ IMF, 2013 GFSR.

¹⁴ IMF, 2013 GFSR.

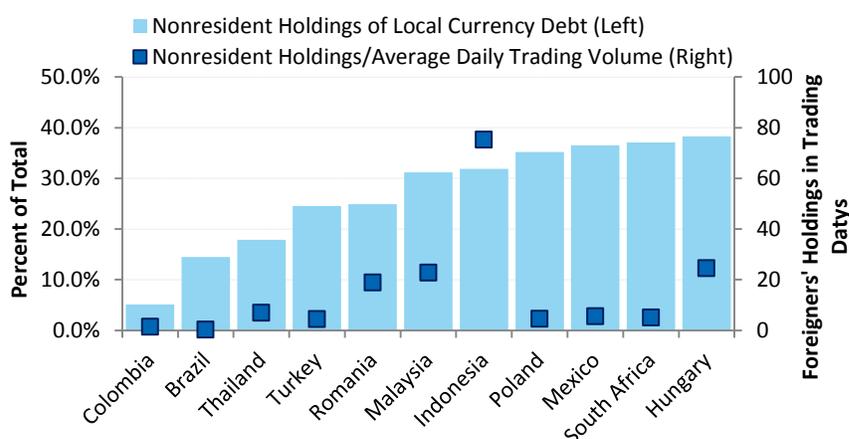
¹⁵ Same indexes cited in (12) above.

¹⁶ IMF, 2013 WEO Database.

¹⁷ Miyajima, K. et al. (2012), “Emerging Market Local Currency Bonds: Diversification and Stability,” Bank of International Settlements Working Paper No. 391.

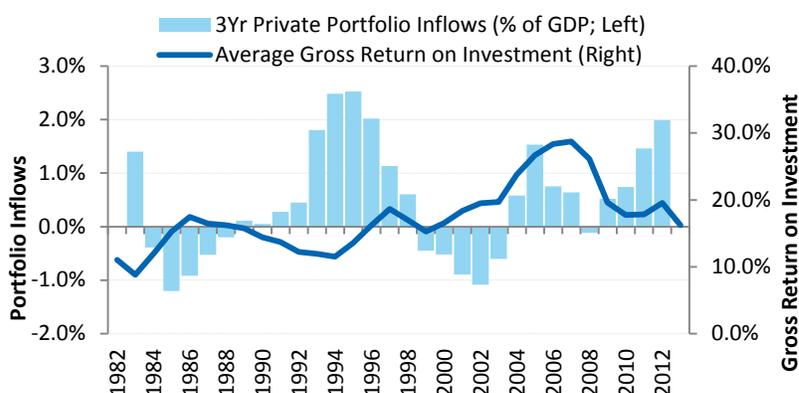
transfer foreign exchange risk to investors. Foreigners' share of local currency debt has increased from zero to 25% or more for number of EMEs (Figure 2). Interestingly, in some cases, the lack of liquidity in local currency bond markets is so acute that these EME governments are partially insulated from extreme downward price movements. In the case of Indonesia, Romania, Malaysia, and Hungary, foreign holdings of local currency debt are equal to 20-to-75-times daily trading volume (Figure 2). As investors likely discovered in the summer of 2013, it is extremely difficult to exit positions without exerting huge downward pressure on market prices. Efforts to unwind existing exposures are likely to be more gradual than they might otherwise be, with greater focus on hedging foreign exchange and selling similar securities in more liquid markets.

Figure 2: Foreigners' Holdings of Local Currency Government Debt¹⁸



Third, returns on capital in EMEs have trended upwards for the better part of thirty years. Between 1980 and 2000, the total return on fixed investment (gross of depreciation) in EMEs averaged 14.2%, just 2.9% more than the 11.9% average in major advanced economies. Since 2000, the differential has grown six-fold to 14.1%, as average returns on capital in emerging markets have increased to 21.4% while developed market returns declined to 7.3% (Figure 3). As many EME policymakers have learned, the best way to short-circuit a boom-bust cycle is to ensure that portfolio flows are used to accumulate productive physical capital that boosts potential GDP. While it would be foolish to expect that each dollar of inflows has been spent prudently, the data suggest a much smaller share of external finance was likely wasted, in aggregate, in the recent period relative to prior episodes.

Figure 3: Emerging Market Returns on Capital and Net Portfolio Flows¹⁹



¹⁸ IMF, 2013 GFSR.

¹⁹ IMF, 2013 WEO Database.

“Pull” from Emerging Markets Will Persist Indefinitely

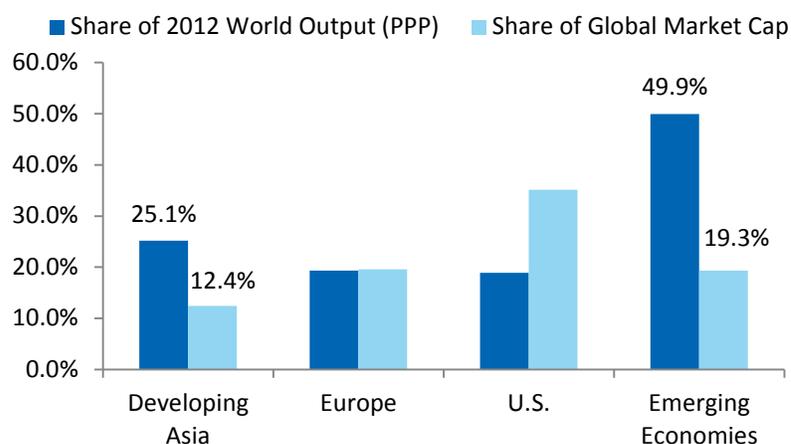
While the withdrawal of liquidity is likely to have significant implications for EME asset prices, near-term volatility is unlikely to have much of an impact on longer-term macroeconomic trends. The return on capital in EMEs is likely to remain substantially above that in developed economies, causing the EME share of global GDP to continue to increase. Over the next five years, the IMF anticipates gross returns on capital will be 5% higher in EMEs than developed markets, even after accounting for the sizeable decline in 2013 and 2014 GDP growth relative to prior expectations (Table 1). At current investment rates, EMEs’ share of global GDP would increase by nearly 1 percentage point per year and reach 54% by 2018.

Table 1: IMF Forecast for 2013 and 2014 EMEs GDP Growth Made in 2011 and 2013

IMF Forecast for 2013 GDP Growth as of...				IMF Forecast for 2014 GDP Growth as of...			
	11-Apr	13-Oct	Difference		11-Apr	13-Oct	Difference
Brazil	4.1	2.5	-1.6	Brazil	4.2	2.5	-1.7
India	8.2	3.8	-4.4	India	8.1	5.1	-3
Indonesia	6.7	5.3	-1.4	Indonesia	7.0	5.5	-1.5
South Africa	4.4	2	-2.4	South Africa	4.5	2.9	-1.6
Turkey	4.1	3.8	-0.3	Turkey	4.1	3.5	-0.6
EMEs	6.5	4.5	-2.0	EMEs	6.7	5.1	-1.6
World	4.5	2.9	-1.6	World	4.6	3.6	-1.0
G-7	2.3	1.2	-1.1	G-7	2.3	2.0	-0.3

Since financial assets represent claims on real economic activity, one would anticipate that EMEs’ long-run share of global GDP would be equal to their long-run share of global business net worth. Although EMEs now contribute 50% of global GDP, the combined market capitalization of domestic EME businesses accounts for just 19% of the global total for listed stocks (Figure 4). The result is a huge disconnect between the size of these economies and the universe of investible EME assets. Investors recognize that they must diversify into EMEs, but the finite supply of liquid assets in EMEs causes asset prices to increase swiftly in response to fund inflows. For this reason, investors must take a contrarian approach to EMEs and increase long-run allocations precisely when illiquidity causes prices to fall. Price declines tied to a diminution of “push” factors are likely to provide attractive opportunities for investors to diversify into EME assets.

Figure 4: Emerging Market Economies’ Share of Global GDP and Market Capitalization²⁰



²⁰ IMF, 2013 WEO Database.

A larger obstacle to efficient diversification is that the universe of investible, liquid assets in EMEs tend to be large firms concentrated in financial services, oil, mining, and other sectors highly correlated with macroeconomic conditions in advanced economies.²¹ Since stocks capturing country-specific risk often account for a small share of total market capitalization, investors buying “emerging market” stock index funds could be mistakenly *increasing* their portfolio’s correlation with developed economies’ risk factors. Moreover, due to less developed financial markets and legal institutions, a much larger share of EMEs’ business net worth is unlisted. EMEs are especially dominated by family-owned businesses, which contribute up to 70% of EMEs’ GDP.²² Any effort to diversify portfolios into claims on country-specific economic activity would be incomplete without an explicit strategy to increase exposure to private, unlisted EME businesses.

Conclusion

Demand for EMEs assets has been boosted by both “push” and “pull” factors. The push towards EMEs will likely diminish as the Fed starts to taper asset purchases and interest rates in developing economies gradually normalize. The pull from emerging markets should remain as strong as ever, as EMEs’ share of global GDP continues to increase. Longer-term investors should treat any decline in EME asset prices associated with tapering as an opportunity to diversify into EMEs at more attractive prices, while also developing strategies to increase claims on the private, unlisted businesses that account for the bulk of economic activity in EMEs.

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²¹ For example, about 45% of the Russian stock market is dominated by five companies in finance or resource extraction: Gazprom, Sberbank, Rosneft, Lukoil, and Norilsk.

²² HSBC, “The Six Hidden Costs of Emerging Markets,” June 2013.