Market & Investment Insights

A new narrative: End of easy money leads to greater differentiation among world's economies

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Article Highlights

- Changing monetary policy and rising interest rates in the U.S. reversed economic trends of the past decade, causing investors to shift funds away from emerging market (EM) assets and reassess challenges facing many emerging market economies in 2013.
- Policy measures will be essential for many emerging- and developed-market (DM) economies to maintain strong growth dynamics and attract investor interest.
- Though rates of growth may be slower and more volatile than over the last decade, long-term growth patterns should continue to favor emerging-market economies.

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From the moment the Federal Reserve decided to combat the recession by expanding its balance sheet, investors worried about the impact on the global economy when the extraordinary stimulus measures ended. They got a glimpse in May 2013, when Fed Chairman Ben Bernanke suggested that the central bank soon might begin paring its $85 billion in monthly bond purchases. U.S. interest rates rose abruptly and, fearing the end of easy money would lead to portfolio losses, many investors fled emerging-market (EM) stocks and bonds in search of other assets though the pace has moderated more recently.

Rising interest rates and a strengthening dollar create challenges for EM fixed-income investors in the U.S., who risk losing money on investments denominated in foreign currencies. Their concerns are reflected in the declining flow of capital into EM investments in 2013, which are estimated to fall by $153 billion, to about $1 trillion, from 2012.[1]

After years of seeing emerging markets as one of the few bright spots in global investing, investors are growing skeptical. As the days of easy money wind down, EM growth rates may be slowing and becoming more volatile, creating new challenges for emerging economies in 2014 and beyond. The countries that manage this declining flow of capital while instituting effective policy reforms are the ones most likely to outperform over the long term and beat back investors' skepticism.

Financial Services

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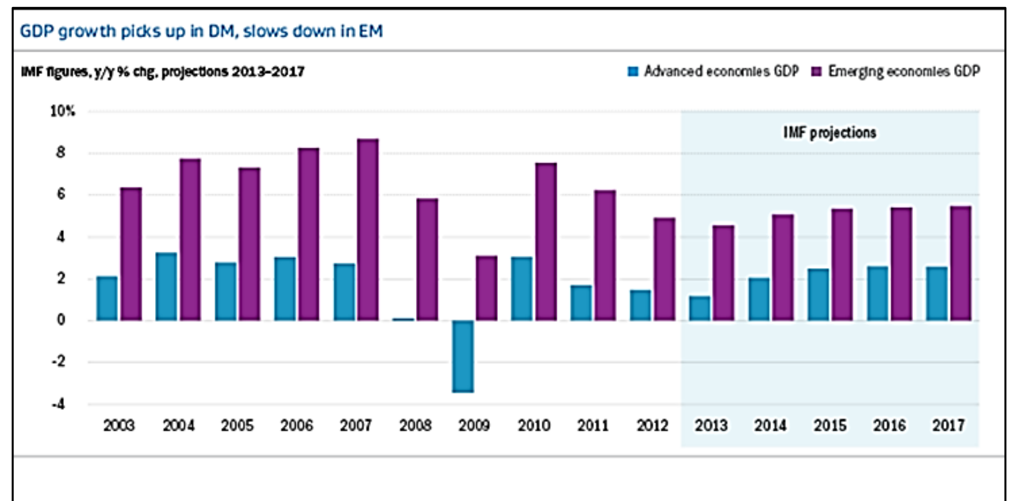
Downward revisions to GDP growth

Rising interest rates alone aren't the reason for investors' skepticism. The average growth rate of all emerging markets slipped more than 2.5 percentage points below its 2010 level, which is expected to create a drag on global growth through 2014. The International Monetary Fund (IMF) recently lowered its global economic growth projections to 2.9% for 2013 and 3.6% for 2014, as shown in **Figure 1**, because of slowing growth in China, India and Brazil. Growth across all emerging markets is expected to slow to 4.5% for 2013, a full percentage point below 2011's level.

Figure 1: GDP Growth



Source: International Monetary Fund figures and estimates as of October 2013.

This slowdown in emerging markets marks a reversal from the past decade, when the growth trajectory of emerging markets outpaced advanced economies and served as the main catalyst for global growth. Emerging markets' share of global gross domestic product (GDP) almost doubled to about 40% of the world's $74 trillion gross domestic product (GDP) in 2013 from about 20% in 2000. During this period, while the U.S., Europe and Japan struggled with considerable debt levels, persistent government deficits, financial crises and stagnant growth, countries such as China, Brazil and India have expanded rapidly. That growth caused EM asset prices to rise and captured investor interest.

As concerns about the end of easy money grew in 2013, however, EM asset classes lagged developed nations, which outperformed market expectations. The 5-year spreads in credit default swaps (CDS), shown in **Figure 2**, illustrate this shift. CDS can be purchased as a type of insurance against defaults or negative credit events, and the spreads indicate investors' risk perception for particular assets. The chart shows that investors viewed countries such as Brazil, Indonesia, and Turkey as riskier than some developed nations such as Spain and Italy after U.S. Treasury yields rose last spring.

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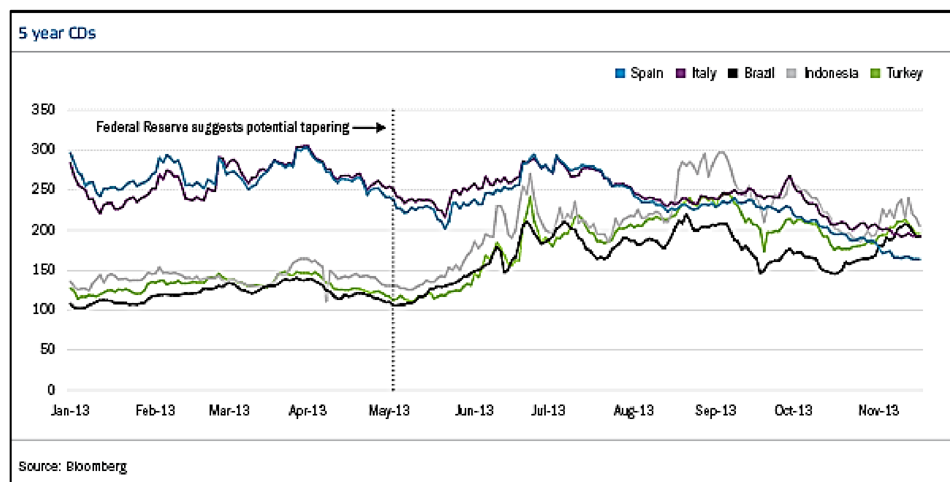
Figure 2: Rising prices for EM credit protection



A new narrative

Despite rising rates and slowing growth, opportunities exist for investors who pay attention to the new narrative for global markets. In the coming years, the distinction between developing and emerging markets will be less important than individual countries' policies and reform strategies. With the large inflows during the past five years, many emerging market countries became lax on policy measures, which has undermined their medium-term growth outlooks. To restore investor confidence and achieve macroeconomic stability, EM countries may need to emulate the focus of reforms demonstrated by developed nations to improve their medium-term outlooks and manage volatile capital flows. Investors have rewarded European countries that have implemented strong structural reforms, made significant progress on current account deficits, and adopted superior fiscal policies to their peers. They may show similar favor to EM countries such as Mexico and the Philippines, in which stronger economic policies and reduced political risk have brightened the investment outlook.

Sound policies are key

At the same time, economies that grew rapidly after the financial crisis, such as Turkey, India and Brazil, now must balance monetary, fiscal, and structural policies as their economies slow. Turkey, for example, has kept interest rates low to stimulate economic growth while risking higher inflation, a weaker currency, and portfolio outflows. Conversely, India and Brazil have tightened monetary policy to anchor inflation expectations, stabilizing their currencies and improving their current account deficits, but at the cost of slower growth.

China is also taking steps to rebalance its economy and generate sustainable growth via a broad economic reform package, announced in November 2013. These measures come in response to rising private sector debt levels and a decline in exports, which have led to downward projections for economic growth. In addition, while Chinese government debt is considered manageable at approximately 50% of GDP, private sector debt is more than 200% of GDP—a level historically considered to be destabilizing. While we view China as having a high capacity and willingness to manage risks, we see slowing economic growth in the short term. We would also

caution that adopting structural reforms carries risks, so policy implementation should be monitored closely as unintended consequences may result.

Long-term growth patterns should continue to favor emerging-market economies

Concerns about global growth aren't limited to emerging markets. Many advanced economies are struggling with years of deleveraging and slower-than-normal growth. In addition, many developed economies face high debt levels, elevated unemployment rates and other structural concerns. Strong policy measures will continue to be essential for developed markets to improve their long-term growth trends and attract investors.

At the same, emerging economies have made substantial changes of their own in the past decade, improving their ability to absorb external shocks such as the Fed's tapering. Many have reduced external debt and accumulated higher levels of foreign exchange reserves, mitigating the risk of balance-of-payments crises. More flexible exchange rates serve as an automatic stabilizer or adjustment mechanism when external shocks present themselves.

We believe emerging markets will continue to drive global growth over the long term, although the rates of growth may be slower, more volatile, and more dependent on stronger policies than they were during the past decade. This new narrative underscores the importance of a disciplined investment approach that incorporates various economic and market cycles over a long-term horizon.

[1] Institute of International Finance data and projections, October 7, 2013.

The information provided herein is as of January 17, 2014.

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