Not all emerging markets are created equal

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Article Highlights:

- Understanding opportunities in emerging markets requires a grasp of the nuances of individual countries.
- Indonesia, the Philippines and Mexico are all worth a close look at this time.
- Indonesia’s appeal lies primarily in the development of its commodity-based industries, thanks to large natural resources of coal, palm oil, copper and gold.
- In recent years, the Philippines has seen a steep drop in inflation, a budget surplus in place of a deficit and a current account surplus.
- Mexico has a growing consumer class and is planning economic reforms including the liberalization of labor markets and incentives for privatizing investments in energy markets.

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Investments in emerging markets have much to recommend them. Long-term social and demographic trends are supporting economic growth and investment opportunity, while many emerging markets suffered less from the global financial crisis than developed markets did. Indeed, some emerging markets are showing a degree of relative stability that historically has been associated with more mature economies. This rapid evolution means that countries now classified as emerging could be considered developed in a few years. And some so-called “frontier” markets, such as the oil-rich United Arab Emirates, may graduate to emerging-market status.

The rapid changes under way in these countries, as well as their diverse economic and investment characteristics, mean that it is essential to make distinctions among individual emerging markets, rather than considering them as a homogeneous bloc. Many U.S. investors still think largely of the four BRIC countries (Brazil, Russia, India and China), whose growth and challenges have been the focus of investor attention for years. But these bellwethers are not the whole story.

Nor does looking at geographic regions provide an adequate level of understanding. It is not possible to draw conclusions based on regional index averages, considering the wide disparity in economic performance or other characteristics of emerging markets countries that make up each region. In Asia,
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for instance, Philippine stocks are up about 42% for the year to date, whereas Taiwanese stocks are up just 12% for the same period, based on MSCI indexes.

A true understanding of the opportunities in emerging markets requires a portfolio manager or analyst to grasp the nuances of each individual country from two perspectives:

- “Top-down” analysis—looking at the macroeconomic, political and regulatory environment of a country.
- “Bottom-up” analysis, focusing on industry sectors and individual companies.

Using these two lenses, it is possible to identify good opportunities in a number of emerging stock markets at the moment—including Indonesia, the Philippines and Mexico.

Indonesia’s appeal lies primarily in the development of its commodity-based industries. With large natural resources of coal, palm oil, copper and gold, Indonesia is benefitting from recent increases in commodities’ prices. More important, however, it is focusing not just on exporting commodities but on processing them—the difference, for example, between shipping blocks of palm fat and upgrading it into palm oil, or between shipping copper concentrate vs. an upgraded, refined and higher-priced version of the mineral. This focus on processing has prompted the government to make policy changes. The country now imposes an export tax on raw commodities as part of an effort to get its trading partners to set up processing plants in Indonesia itself. In doing so, government officials have two goals: to create jobs domestically and to generate a transfer of knowledge from more sophisticated economies to Indonesia. The idea is to push Indonesia in the direction of having a more skilled and educated work force.

Such development of human capital will be essential to the advancement of the fourth most populous nation in the world, with an average age of 28 (versus 35 in China and 37 in the U.S.). Indonesia’s population is increasingly middle class, not just in the capital, Jakarta, but throughout the country. Evincing their interest in technology, Indonesians are among the heaviest users of Facebook in the world.

The Philippines is also on the rise. Many investors have traditionally ignored this island nation, which has operated in the shadow of Indonesia and other Asian countries like Thailand and Malaysia. In recent years, however, the Philippines has had a dramatic macroeconomic turnaround. The changes include a steep drop in inflation, a budget surplus in place of a deficit and a current account surplus. One result of the robust economics has been a very stable currency—something that has given investors confidence and allowed the stock market to perform well. The Philippines also has among the world’s highest inflows of remittances, the money sent back to a country by those who have left it to work overseas. Remittances have helped power GDP growth in the Philippines, which was 4.7% on an inflation-adjusted basis in 2011.

Another growth prospect is Mexico, whose close trading ties to the U.S. means it may do well when the U.S. economy picks up steam. The country also has a growing consumer class contributing to the domestic economy, which has helped offset sluggish export growth in recent quarters. Mexico also has some other positives, including expected reforms in the areas of labor law and the oil industry.
Over the next few years, several economic reforms will be on the country's legislative agenda, including the liberalization of labor markets and incentives for privatizing investments in energy markets.

Of course, not all emerging markets currently offer compelling investment opportunities. In Taiwan, for example, the economy is overly dependent on low-margin hardware and electronics industries; as a result, the TIAA-CREF Emerging Markets Equity Fund has a smaller allocation to this market, relative to the fund's benchmark. Another underweight versus the benchmark is South Africa, whose major industry, mining, has lately been plagued by labor strife and violent government crackdowns.

These examples demonstrate that there are risks in emerging markets—just as there are in all equity markets. A sound approach to investing in these markets is one that recognizes both the potential opportunities and the inherent risks. Understanding these aspects of emerging-markets equity investing can help long-term investors determine an appropriate allocation to this asset class as part of a diversified portfolio.