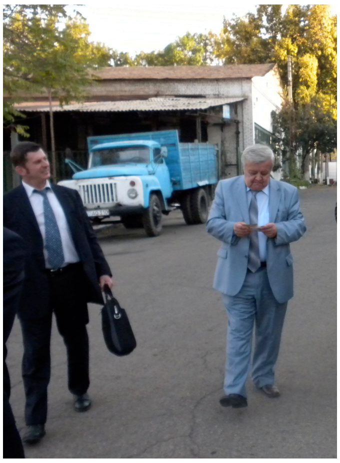
2013 : Investment Adventures in Emerging Markets

The outlook to a considerable extent reflects the view that emerging economy growth will continue to be higher than that of developed countries. Their debt on average will remain much lower, and their demographic age much younger. In addition, the inevitable policy response of developed economies to slower growth will be to reflate in order to minimize the impact of the structural headwinds.



The “year of the dragon” in 2012 certainly didn’t disappoint, as the global markets battled one financial dragon after another. From the Eurozone’s sovereign debt crisis to persistently high unemployment in the U.S. and a mayday call from many who worried that China’s growth rate was headed for a “hard landing,” 2012 certainly was interesting.

The Ripple Effect

In this interconnected world, what happens in the key economies of the U.S., Eurozone, and Japan this year will almost certainly impact the global economy at large, but the ebb and flow of action and reaction is shifting.

Emerging markets, for instance, are generally lessening their trade dependence on the U.S. and Europe, and there are other countries that can drive global growth—some of which may even surprise us in 2013.

The US, Japan, Britain, as well as the Swiss, Scandies, and a string of states around the world, are actively driving down their currencies or imposing caps. The side-effects of this currency warfare -- or "beggar-thy-neighbour’ policy as it was known in the 1930s -- is an escalating leakage of monetary stimulus into the global system.

The headwinds of deleveraging will return with gale force. The glut of excess global savings that lay behind the great crisis of 2008-2009 -- and that has kept us stuck in the Long Slump ever since -- is still getting worse. The international trading system remains badly out of kilter. There is chronic overcapacity across global industry and not enough demand to carry a full cycle of economic expansion, or to reach "escape velocity" as they say these days.

Emerging markets in general have had three characteristics in their favor: generally high economic growth rates, large amounts of foreign reserves and low foreign debt. Many emerging economies appear to be on the cusp of consumer booms as well as productivity advances, which should bode well for future growth potential.

Visualizing The Changing Face Of Global Manufacturing

Take for instance the manufacturing industries that have helped to drive economic growth and rising living standards for nearly three centuries, and for some developing economies (as McKinsey notes in a recent report) continues to do so.

Things are changing, however, as manufacturing output (as measured by gross value added) grew by 2.7% annually in advanced economies and 7.4% in large developing economies (from 2000 up until 2007); the leaders are changing rapidly China, India and Russia rise and Germany, Japan, UK, and Canada are sliding. The following chart simplifies the evolution of global manufacturing economies over the last four decades.

Large developing economies are moving up in global manufacturing

Top 15 manufacturers by share of global nominal manufacturing gross value added

Rank	1980	1990	2000	2010
1	United States	United States	United States	United States
2	Germany	Japan	Japan	**China**
3	Japan	Germany	Germany	Japan
4	United Kingdom	Italy	**China**	Germany
5	France	United Kingdom	United Kingdom	Italy
6	Italy	France	Italy	Brazil
7	**China**	**China**	France	South Korea
8	Brazil	Brazil	South Korea	France
9	Spain	Spain	Canada	United Kingdom
10	Canada	Canada	Mexico	**India**
11	Mexico	South Korea[1]	Spain	**Russia**[2]
12	Australia	Mexico	Brazil	Mexico
13	Netherlands	Turkey	Taiwan	**Indonesia**[2]
14	Argentina	**India**	**India**	Spain
15	**India**	Taiwan	Turkey	Canada

1 South Korea ranked 25 in 1980.
2 In 2000, Indonesia ranked 20 and Russia ranked 21.
NOTE: Based on IHS Global Insight database sample of 75 economies, of which 28 are developed and 47 are developing. Manufacturing here is calculated top down from the IHS Global Insight aggregate; there might be discrepancy with bottom-up calculations elsewhere.
SOURCE: IHS Global Insight; McKinsey Global Institute analysis

Frontier Markets

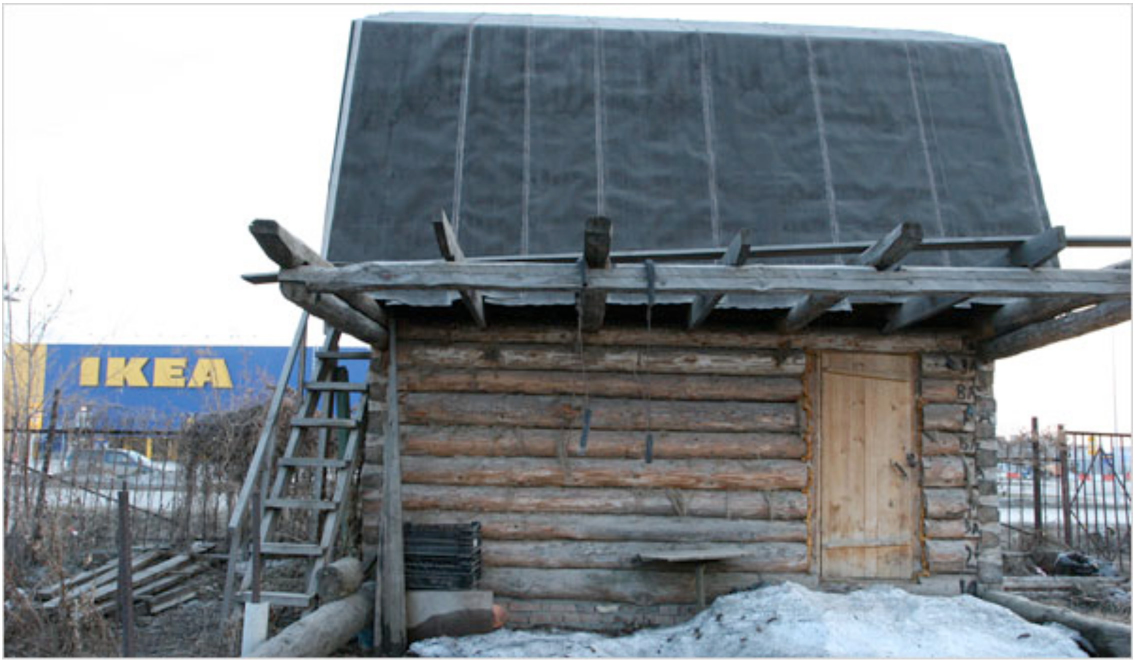
I’m particularly optimistic about the investment potential in the frontier markets, the lesser-developed of the emerging markets.

As exciting as they can be, one must be selective and very patient when investing in these markets. We have to look out well beyond one or two years, and generally take a five-year view. Growth rates in many frontier markets exceeded those of developed markets by a wide margin in 2012, and I believe that trend is likely to continue. The IMF has projected that during the next five years, 10 of the 20 fastest-growing economies will be in Sub-Saharan Africa, and two in North Africa. None are in the Western Hemisphere.

I anticipate growth in many frontier countries’ capital markets, too. Some of these markets are moving from small and illiquid to large and liquid.

Overall, as frontier market countries expand, they have continued to increase investments in infrastructure, offering investment opportunities in construction, transportation, banking and finance and telecommunications industries. Many frontier countries are leading producers of important commodities such as oil, gas and precious metals, making them well positioned to potentially benefit from anticipated growing global demand for these resources. Rising consumption can provide these economies with strong purchasing power and the ability to spend their way to growth.

Many frontier market countries have continued to be positively impacted by the substantial investments made by large emerging market countries such as China, India, Russia and Brazil. The economic drivers across frontier markets are diverse. For example, Botswana, one of the world’s largest diamond exporters, is introducing call and data processing centers. Kazakhstan, a country rich in oil and other natural resources, is investing in infrastructure development.



Low Interest Rates… and Inflation

Given the fragile state of many of the developed markets right now, it seems likely that central banks could continue pumping money into the system. From an investment standpoint, it’s also possible that investors seeking yield in a prolonged low-rate environment could respond by funneling more money into stocks.

I believe ‘quantitative easing’ could be particularly good for emerging markets, at least in the short run, because it means there’s lots of cash in the system. This trend was evident in 2012, as investment inflows into emerging markets equities totaled approximately US $35 billion in the first 11 months of 2012.

I expect this trend could continue in 2013. With interest rates remaining very low, stocks can look more attractive to many investors.

The flip side of the cash flood coin, of course, is the potential for inflation. In emerging economies, a larger percentage of the population is in lower income brackets, so price increases in essentials such as food and fuel can be harder to absorb. Increased productivity can help lessen the impact of inflation.

In order to achieve this, I believe economies with heavy-handed government policies may need to reduce the role of government. Our job as an investor is to scour these countries for individual companies that show potential to be able to survive, and even thrive, in the face of these challenges.