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Secular Outlook Series

Issue 4, June 2012

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Emerging Markets Converge With the Developed World

What defines a developed nation? Emerging economies are growing faster and with enviable balance sheets relative to developed countries.

In the following interview, portfolio managers Michael Gomez and Lupin Rahman discuss the evolution of emerging markets (EM), including challenges policymakers face and opportunities and risks for investors.

Q: What is the secular outlook for emerging economies?

Gomez: Emerging markets are playing an increasingly important role in the global economy – a trend we expect to continue and potentially accelerate over the next three to five years.

We expect to see growth moderating in emerging economies over the secular horizon, but still outpace growth rates in Europe and the U.S. Specifically, we see emerging economies expanding at a rate of 5% over the next few years, down from our previous forecast of 6%. That rate is still favorable vs. the 1% growth rate we anticipate for developed economies, down from our previous 2% forecast.

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This should translate to a greater share of emerging markets in the global economy with emerging markets expected to account for more than 50% of global GDP over the next few years. This long-term convergence may be more volatile in the years ahead as emerging markets are likely to be affected by the considerable growth headwinds and uncertainty emanating from the developed world.

Q: Could you elaborate on the outlook for the leading economies – India, Brazil, Russia and China – as well as policy in those nations?

Rahman: An important feature of the emerging market investment landscape is that we are likely to see much greater differentiation across emerging countries than before the crisis. This will be driven largely by each economy's initial conditions, including the state of their balance sheet and savings cushions, as well as their policy flexibility to adjust to external and domestic shocks. The more uncertain and volatile global backdrop we foresee over the next few years will therefore give rise to some economies faring better and "emerging" faster than others. Also, we believe policymakers need to make substantial progress on several types of reform.

In Brazil, we are likely to see some moderation in economic growth as the commodity tailwind the global economy experienced in the last decade tapers. Offsetting this is the economy's vast domestic market which means there is considerable scope for internal demand to pick up the slack. In addition, Brazil is making progress on important structural factors such as lowering the anomalously high real interest rate and focusing on state-directed investment. However, we believe more needs to be done to reduce the government's fiscal footprint and increase incentives for private investment and entrepreneurship.

Two secular plusses for Russia's economy are the country's substantial currency reserves and the increased flexibility in the ruble, both of which could help weather external headwinds. Yet, in a world where global demand is softer and exploration of alternative energy sources is increasing, Russia needs to make further progress on investing in the energy sector and reducing its high economic dependence on oil. We will be watching for progress on this front and how the Putin regime deals with increased calls for greater democracy and representation.

We see enormous growth potential for India, but also large and significant structural challenges. These emanate largely from political stasis and lack of progress in tackling important structural issues, both of which are coming to a head and pose important challenges for the economy.

Finally, we think the key issues for China are whether the economy is able to shift to domestic-demand-based growth from a reliance on exports and if the political transition set for 2013 will enhance or hinder this process. *(For more on China, see the Secular Outlook Series Q&A on Asia.)*

Q: How might EM central bank policy evolve over the secular horizon?

Gomez: As PIMCO Chief Executive Mohamed El-Erian noted following our Forum, monetary policy in the developed world is in real-time experimentation mode, with the risks of additional financial repression likely to be high over the medium term.

Against this backdrop, EM central bankers are likely to be highly accommodative. Yet they still have to navigate growing inflationary pressures, disruptive surges in capital inflows, and, as mentioned earlier, slowing and more volatile growth.

Remember that most central banks have not fully normalized monetary policy enacted in the aftermath of the 2008 financial crisis. We think this, together with global tendencies toward inflation and muted growth, mean EM central bankers will leave policy rates on hold for longer. They will also rely disproportionately on non-interest tools such as reserve ratio requirements, liquidity provisions and directed credit to ease policy.

Indeed, we have seen certain EM central bankers shifting to a dual focus on inflation and exchange-rate targeting. China's policymakers have done this for some time, and such a shift has also become more evident in Brazil and Turkey. If not managed delicately, these policies entail risks for the long-term credibility of central banks and ultimately may start to imperil inflation expectations.

Lastly, some EM central bankers have attempted to accelerate reforms with the goal of lowering high structural real interest rates; examples include Brazil and potentially Mexico in the future. This results from more accommodative monetary policy and ought to be accompanied by productive and long-term structural reform.

Q: How would the outlook change depending on the future of the eurozone?

Gomez: Events in the eurozone – and the need for an orderly solution to the challenges to growth and debt sustainability there – are of utmost importance to both developed and emerging economies.

Emerging economies entered this period of global uncertainty with relatively clean balance sheets, reasonably high degrees of policy flexibility, and substantial dry powder in the form of international currency reserves.

However, a delevering, slowing Europe will adversely impact EM trade flows, financing and growth (which is partly why we have trimmed our growth expectations for emerging markets). Emerging economies with relatively higher levels of leverage and those most connected to Europe are likely to suffer disproportionately.

To be sure, we would expect a disorderly fragmentation of the eurozone to negatively affect the growth outlook for emerging economies in a fashion potentially similar to what we saw during the 2008 financial crisis.

Q: How should investors be thinking about and potentially investing in emerging markets in their portfolios?

Rahman: Investors should seek to manage the greater differentiation that we anticipate among emerging markets over the secular horizon. One way to do this is to focus on investments with a bias towards higher quality credits, particularly those with solid balance sheets and limited leverage, as well as those that can potentially withstand a more negative global backdrop. In order to identify these, investors should look to reconsider labels that separate emerging market investments from their developed world counterparts, and instead focus on how investments *behave*, particularly important considering the growth and debt dynamics in both markets.

Investors should also reconsider benchmarks. In particular, they may benefit from a benchmark that has a higher weight of countries that are contributing more to the productivity of the global economy than to a benchmark based on market capitalization of sovereign debt, which gives greater weight to more levered balance sheets, for example, developed markets.

Gomez: I'd add that we believe the global economy will continue rebalancing, with the developed world generally saving more and the emerging world generally consuming more going forward. These changes should continue to support the long-term appreciation of emerging market currencies, with periodic cyclical volatility. We see Asian currencies at the center of this trend, led by the increased internationalization of the Chinese renminbi.

In all, over the secular horizon we believe emerging market investments in many cases may offer not only better fundamentals, but also the potential for higher yields and more compelling total returns than traditional developed world alternatives.

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