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Buttonwood

The last great hope

Emerging markets may be the next bubble

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THE internet allowed people to pay lower prices for books but also encouraged them to pay stratospheric prices for shares in lossmaking dotcom companies. During the subprime boom Americans believed the illusion that they could get rich by buying each other's houses.

Those dreams may have been shattered. But hope springs eternal. There is still one great hope left for investors: emerging markets. Fund managers have been making the case for emerging markets on a regular basis over the past 20 years. Developing countries offer higher economic-growth rates, have younger, more dynamic populations and are under-represented in the global stockmarket. Buying a stake in emerging markets is like buying a stake in the future.

Goldman Sachs, for example, reckons that the total capitalisation of emerging markets will rise from $14 trillion today to $80 trillion by 2030, increasing from 31% of the global total to 55% in the process. Even allowing for new equity issuance, that will still translate into an annualised return of 9.3%, Goldman estimates, compared with just 4% for developed markets. It seems like a no-brainer.

But experience should teach investors to be suspicious of no-brainer decisions. The same arguments were advanced in the early 1990s, after all. But between 1991 and 2000 emerging markets delivered a total return of just 38% and developed markets returned 171%. Outperformance came only in the decade just gone, with emerging markets almost quadrupling investors' capital since the end of 2000.

A caveat also needs to be applied to the growth case. Elroy Dimson, Paul Marsh and Mike Staunton of the London Business School examined their database of 17 national stockmarkets since 1900. Using a variety of tests, they found virtually no correlation between an individual country's GDP growth rate per head and the returns to investors.

What is the explanation for this rather counter-intuitive result? One answer is that a stockmarket is not a perfect facsimile of an economy. Many companies are unquoted. Those businesses that have floated on the market may be mature, or slower-growing, or simply overweight in one sector. In 1900 Wall Street was dominated by railroad stocks, for example.

A second answer is that growth countries may behave like growth stocks. A period of strong performance leads to overvaluation, from which subsequent returns are inevitably disappointing.

Has that stage arrived? The old rule of thumb was that emerging markets were pricey when they traded at a higher multiple of profits than their developed counterparts, as they did in 1999 and 2007 just before sharp falls in prices. At the moment they trade at a modest discount.

But emerging markets are prone to boom-and-bust cycles. They have suffered three 25%-plus losses in the past 20 calendar years, and five years in which annual returns have exceeded 50%. International investors have probably been behind much of the volatility, pushing the markets this way and that as they switch between enthusiasm and risk aversion.

It is quite possible that another boom is on its way. Bubbles, as described by Charles

Kindleberger, a financial historian, usually involve an initial displacement, followed by rapid credit creation and then a phase of euphoria.

The displacement may have been the financial crisis of 2007-08 which undermined the solvency of the developed world. As governments propped up their banks, their debts soared. On average emerging-market governments now have much lower debt-to-GDP ratios than their developed peers. Economic power seems to have made a decisive shift.

The crisis was followed by the slashing of interest rates in the developed world. These have had a limited effect in reviving lending in Western economies. But they have encouraged Western investors to buy higher-yielding assets, like emerging-market equities. Emerging-market equity funds have already received inflows of $45 billion this year, according to EPFR Global, a research group. And low rates will also boost credit creation in those developing countries that import American monetary policy via managed exchange rates.

Euphoria will follow as cheap money drives up asset prices—this may have already happened in parts of the Asian property market. Investors probably have no option but to ride the wave, if only because the outlook for developed markets looks so flat. There is, at least, more solidity to emerging markets than there was to dotcom stocks.

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