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Emerging Market Decoupling: True, False, or Partially True?



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There is nothing like a brutal bear market to test widely held assumptions that helped to fuel the immediately preceding bull market. Arguably the biggest lesson learned over the past 18 months is that systemic risk is not some quaint concept that a future generation may need to address. Another victim of the current malaise is the notion that emerging economies and markets are not a high beta extension of activity in the developed world, but that their long-term growth and increasing financial stability would largely insulate them from adverse developments in the U.S. and other developed regions. If henceforth investors do position their global portfolios on a no-decoupling basis, they may be at risk of leaving a good source of return on the table if the notion of decoupling is wholly or at least partially true.

Through mid-2008, emerging markets held up relatively well in the unfolding global credit crisis. In the course of 2008's third quarter, and particularly after the collapse of Lehman and the bail-out of AIG in September, emerging markets contracted viciously. The combination of sharp commodity price declines, and a frantic global rush to reduce leverage and repatriate capital to plug domestic holes, precipitated a herd-like retreat from almost all major emerging markets, which had received disproportionately high flows in the prior years. As the accompanying table reveals (next page), in less than five months (from the end of May through late October) the carnage was universal. Emerging markets bore the brunt of this, with individual major markets down anywhere between 45% and 70%.

The retreating elephants also forced severe devaluations of most of the emerging currencies, particularly versus the U.S. dollar, between July and October.

What began as a global credit crisis emanating from "the West," has since effectively derailed the global economy. Assuming 2009 is the calendar year in which the global economy is at its nadir, the expected growth for 2009 makes sober reading. Contracting consumer demand in the U.S. and Europe has hit large exporters of consumer goods especially hard, with South Korean, Taiwanese, and Japanese economies all expected to contract by more than 5% this year. Even China has wobbled, and has seen its growth rate come down from 10% to an expected 4%. India is coming through relatively unscathed, as it is not a large industrial or consumer product exporter while its service exports remain fairly stable. Brazil is expected to have a mild recession, while Mexico, as a swing producer for the US, is faring much worse. Eastern Europe, as developed Europe's swing/outourcing partner, has also seen its fortunes decline sharply. In South Africa the recession is projected to be mild.

If the rejection of the decoupling thesis is fully valid, global market events since late October do not underscore this. While October/November was the trough for emerging markets as a whole, the major U.S., European, and Japanese markets fared badly after this and reached, albeit conditionally, a low in early March. Despite the sharp recovery in March, the developed markets are still near their October levels.

With some exceptions, the emerging markets are well above these lows. Assuming the global sell-off culminated into this March low, if emerging markets are a high beta play why would they have bottomed fully six months before those in the U.S., Europe, and Japan? The notable exceptions are the “swing” producers (Eastern Europe and Mexico) where the case for decoupling should arguably never have been made in the first place.

While the global economy is nowhere close to being out of the woods, recent indicators – from U.S. housing to Chinese production – are not quite as dire

as markets had been anticipating. The G-20 meeting in London appears to have concluded on a fairly constructive note. Consumption growth in the developed world will remain constrained, however, for the time being. The prospect of demand stabilization, the unfreezing of trade credit, and domestic demand growth in the emerging economies is a package deal on balance good for the emerging markets. Eastern Europe and Mexico may not recover quickly, though, and remain outside the decoupling equation. On balance, it looks as if emerging markets are playing a leading indicator role for the developed markets. Times have indeed changed. ■

Emerging Market Decoupling: a Nuanced Tale

| Country | GDP 2009 % growth (est.) | Current account to GDP (%) 2009 | USD 5/31/08-10/24/08 | USD 10/24/08-04/02/09 | Local Index |
|------------------------------|-----------------------------|------------------------------------|-------------------------|--------------------------|----------------|
| Developed | | | | | |
| US | -2.2 | -3.3 | -37 | -4 | S&P 500 |
| Euro Zone | -2.4 | -0.8 | -52 | 1 | DJ Euro |
| United Kingdom | -3.1 | -2.0 | -48 | 0 | FTSE 100 |
| Japan | -5.3 | 2.0 | -35 | -2 | Topix |
| Emerging/Developing | | | | | |
| Asia | | | | | |
| China | 6.0 | 6.1 | -45 | 32 | Shanghai Comp. |
| India | 5.0 | -3.7 | -55 | 18 | Sensex |
| S. Korea | -5.9 | 1.2 | -63 | 46 | Kospi |
| Taiwan | -6.5 | 7.9 | -49 | 20 | TWSE |
| Latin America | | | | | |
| Brazil | -0.4 | -2.2 | -70 | 43 | Bovespa |
| Mexico | -2.6 | -3.4 | -55 | 7 | Bolsa |
| Eastern Europe/Africa | | | | | |
| Czech Republic | -2.0 | -2.3 | -59 | -5 | Prague S.E. |
| Hungary | -3.0 | -3.7 | -62 | -3 | Budapest S.E. |
| Poland | 0.7 | -4.9 | -60 | -5 | WIG20 |
| Turkey | -2.0 | -3.4 | -56 | 17 | ISE Natl 100 |
| South Africa | -0.8 | -7.0 | -60 | 42 | JSE All Share |

Sources GDP/Current Account: *The Economist*, March 28th; Market returns: Bloomberg

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