Are Emerging Markets the Next Developed Markets?

BlackRock Investment Institute
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Executive Summary

- The emerging markets (EMs) have provided major investment opportunities over the last decade—whether in the equity, fixed income or currency spaces.
- The global growth landscape and investment opportunity set have changed significantly in recent years, but allocating to emerging markets remains, in our view, a core investment strategy.
- As emerging market economies have grown and converged with their more developed counterparts, the long-time—and much trumpeted—EM diversification benefit for investors has, in our view, somewhat abated. We believe that diversification in itself no longer provides an adequate justification for investing in emerging markets.
- At the same time, while a macro focus might once have been sufficient for crafting an effective EM investment strategy, investors must now balance both macro and micro considerations when approaching these markets. In this regard, emerging markets have come to more closely resemble their developed market (DM) counterparts—and accordingly, investors must drill down to the sector, company and security levels to achieve their investment goals.
- The EM story encompasses much more than China—but that country’s importance to the emerging markets and the broader world economy is undeniable and considerable. We are concerned about China’s financial imbalances, but believe that there will be a slowdown in the growth rate for the country rather than a retreat or crash, and that opportunities continue to abound for investors.

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We believe that close monitoring of political and corporate governance issues is essential. We also think that investors should be encouraged by the broad improvements that have been made in these areas across the emerging markets—even as we acknowledge that enhancements must continue to be implemented.

Inflation, income inequality and the interconnection of these two realities to social unrest still represent a significant long-term challenge to EM growth. Faced with the prospects of rising rates or sputtering growth, many EM policymakers will, in our view, likely allow for the appreciation of their currencies.

We believe that there will be a switch over time from economic policies based on mercantilism and foreign exchange reserve accumulation towards domestically led growth. This long-term trend will have profound implications over time for global asset allocation in particular, as lower growth rates of reserve accumulation force the burden of funding Western fiscal deficits onto the domestic saver constituency.

Among other issues that pose significant potential limits to ongoing growth are natural resource constraints, the “middle-income trap,” volatile financial capital inflows, managed exchange rates (and potential asset misallocation arising from this process) and shallow domestic financial market infrastructure. We contend that, in general terms, these are constraints on medium-term growth rates and not insurmountable barriers.

On a more optimistic note, the next decade will be marked by new global leader companies emerging from inside these countries to join the existing group of such leaders from more developed markets. Success stories will be joined by new names in industries such as pharmaceuticals, machinery and food manufacturing.

We also see a key trend in the deepening of domestic financial systems as welfare programs develop to meet the longer-term challenges of aging populations. Deeper domestic financial systems should provide greater ability to absorb challenges from short-term capital flows and the resulting macroeconomic volatilities.

One particular issue to address is the inconsistent linkage between high growth and high returns to investors. Much corporate growth is financed through equity issuance, given the general lack of depth in domestic bond markets. This often leads to dilution of existing stakeholders both at individual and national stock market levels, and caps returns per share or unit of investment.

While a number of challenges loom, we believe that the emerging markets’ share of world financial assets will increase materially over the next decade both through price appreciation and capital issuance. Developed market companies’ activities will in general terms continue to skew towards these economies. In short, by 2020 the investment world is expected to be spending even more time on the emerging markets than is the case today. In this new landscape, developments in Beijing, Mumbai and Sao Paolo will, in our view, require as much study as those in New York, London and Frankfurt.
Section I: Introduction

For more than two decades, emerging markets (EMs) have generated some of the most exciting investment opportunities globally. As economies in Asia, Latin America and Eastern Europe began to grow at rates that far outpaced more developed countries, new economic reforms and trade liberalization opened the door to Western investment. Meanwhile, increasing urbanization and a burgeoning middle class gave rise to a new generation of consumers with strong demand for consumer goods and infrastructure development to support their new lifestyles. As a result of these developments, investors were able to enjoy a period of exceptional returns across major asset classes.

Today, however, EMs present a very different investment proposition, having established themselves as major players in the global economy. Compared to Western countries, many emerging markets are better resourced, have stronger balance sheets and younger work forces. China and India together comprise three times the population of the entire advanced world.

Emerging markets now represent 86% of the world’s population, 75% of the world’s land mass and resources and account for 50% of world GDP at purchasing power parity (PPP), yet account for just 12% of the global equity market capitalization on a float-adjusted basis.1

Emerging markets, of course, come in many sizes and forms. There are limited similarities between the financial structures and investment return drivers of a highly developed economy and financial system such as, say, South Korea and those of the frontier markets of Africa and Central Asia.

GDP per capita is in some cases higher in emerging market countries than in the poorer developed countries, so Korea and Taiwan, with GDP per capita of $22,000 apiece, have higher ratios than many European countries. On the other hand, there are a number of EMs with very low ratios, such as India, with GDP per capita of just $1,500. The frontier countries are even more extreme, ranging from the oil states of Kuwait and Qatar—which are among the wealthiest in the world—to African states with GDP per capital of less than $1,000.

However, some of the poorest countries are also some of the fastest-growing globally. Overall, emerging growth is significantly faster than in the developed world, but there are significant variations—ranging from Qatar, with forecasted GDP growth of 20% this year, to the Czech Republic, with forecasted growth of just over 2%. There are huge differences between Russia and Brazil, which benefit from rising commodity prices and importers such as Turkey and India, which struggle with rising prices. So again, we have to be careful with generalizations: Korea and Taiwan have economies that are closely linked to global growth, while India’s economy is much more driven by domestic factors. A slowdown in EMs is not the same as a slowdown in developed markets (DMs). For China, a slowdown means going from 10% growth to 7-8%, while a 2% slowdown implies a full-blown recession for many developed countries.

EM demographic factors are much more positive than in developed countries, with younger and growing populations and, therefore, a growing workforce in contrast to the declining workforce and rising dependency ratios of the developed world. This is especially the case in frontier markets such as in Africa, which have the youngest and fastest-growing populations.

The development of financial systems and the rule of law will also be key to advances in emerging stock markets. Some countries have made good progress and score relatively highly in these two areas, such as Taiwan and Hungary, while significant concerns remain about corruption and governance in places like India and Russia. This is frequently reflected in lower valuations in more corrupt countries, but also presents an opportunity for improvements, leading to higher standards and higher valuations.

Liquidity is one of the criteria all investors should take into consideration. One factor is state ownership, which reduces the size of the free float and also affects standards of governance. In general, the largest markets have traditionally been the most liquid—South Korea, China, Brazil and Taiwan—while Colombia and Philippines have been relatively illiquid. Frontier markets have been even more illiquid, so investors should consider focusing on the largest companies in those markets, or they could consider a longer holding period. A related issue is the volatility of share prices—emerging markets remain significantly more volatile than developed markets, particularly in times of stress.2

Some markets, of course, will eventually ascend to developed market status—Korea and Taiwan, for example, are regularly reviewed for such a move. Many of the most exciting opportunities now lie in the frontier countries, which are not included in today’s EM indices but which could be the emerging markets of the next decade. A handful of emerging markets have deep domestic bond markets with fully developed yield curves—for example, South Africa and India—whereas many other countries have very shallow domestic bond markets (such as China). Likewise, currency markets come in all shapes, sizes and form with pegged rates, crawling pegs, managed floats, partial floats and freely floating currencies—the latter, sadly, the least-common species.

1 Source: Merrill Lynch, BP, CIA World Factbook, IMF World Economic Outlook, MSCI. 2 As an example, EM vol in US dollar terms at the peak of the credit crisis spiked to 0.69, compared to MSCI World vol of 0.43.
Perhaps the most compelling indication of emerging markets’ newfound global stature was their rapid recovery from the 2008 credit crisis. Indeed, many experts have argued that developed markets would not have bounced back were it not for China’s continuing demand for commodities. We believe this ongoing economic convergence with developed markets means that investors need to think about emerging economies differently.

Much of this paper focuses on mainstream emerging markets—the 20 or so countries that comprise some 80%-plus of the current investment opportunity. Frontier markets deserve a paper of their own, and the BlackRock Investment Institute will be returning to this subset of the overall opportunity in a future paper.

Growth: Divergence, Convergence and Beyond

Historians, economists and anthropologists have long puzzled over the varying pace of development in different regions of the globe. As recent examples, Professor Ian Morris of Stanford University in his 2010 magnum opus *Why The West Rules For Now* traced relative indices of social development between East and West back to 14,000 BC, and Professor Angus Maddison, formerly of Groningen University, produced a controversial but detailed calculation of country and regional shares of world activity back to AD 1 that illustrates the rise and fall of West and East over the last two millennia.

In more recent times, the period from the dawning of the Industrial Revolution in the UK around 1709 (dated to the construction of a still-standing and remarkable cast iron bridge across the IronBridge Gorge in Shropshire) saw a considerable acceleration of the West relative to the East. From that time, the US and Western Europe embarked upon sustained and unprecedented rises in income per head and in productivity, and continued along that path for the better part of two centuries. Meanwhile, income per head in Asia actually declined, so that the difference between the richest countries and China fell to two to one. By the middle of the 20th century, this discrepancy had grown to 30 to one, exacerbated by dreadful wounds such as the Cultural Revolution in China, the post-1947 Partition of India and the Vietnam War. In Latin America, the lost decades of hyper-inflation and military populism from 1950 until the early 1990s impeded development. Emerging Europe slumbered and decayed during the Cold War, while Africa struggled to cope with the vicissitudes of the post-Colonial era. In short, the West got lucky and the rest of the world did not. However, since the mid-1980s the tide, in our view, has turned, with the emerging economies surviving the wrenching financial crises that lasted from the devaluation of the Mexican peso in December 1994 until the Argentinian devaluation of 2001 to emerge with growing shares of world output and capital markets.

In recent years, emerging market growth has outstripped the developed markets3. Figure 1 below charts emerging market versus developed market growth since 1989 on a 10-year trailing basis. In the ‘80s, GDP growth in the developed and in the emerging worlds was essentially the same. But between 2000 and 2010, average growth in the emerging world rose to the point where it was three times higher, driven largely by the Asian economies.

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3 Emerging markets and developed markets were historically defined by respective measures of economic development. Today, the boundary between these two groups is only loosely defined—for example, Taiwan and South Korea are clearly developed nations in all senses. We take the term “emerging” to refer to countries whose stock markets are not components of the MSCI World Equity Index, and “developed” as those who are solely included in this index. This investment-defined differentiation, though far from perfect, is convenient for investors in terms of portfolio management determination.
Moreover, as emerging economies have grown, the output of developed economies has been shrinking—a situation that is almost entirely explained by growth in Asia. The IMF data expressed in Figure 2 on the previous page asserts that from 1992 to 2015, advanced countries are expected to decline by 17% of total GDP—an unprecedented rate of deterioration. Developing Asia accounts for most of this drop, with growth expected to be 18% within the same timeframe. The rest of the emerging world’s weight in the world economy will remain roughly constant.

The export share for Brazil underlines the emergence of a new core to the economic system. At the beginning of 2001—just 10 years ago—the United States dwarfed China as a market for Brazil. But in 2009, China’s share began to exceed that of the US, and China’s share of Brazil’s exports is now up to 15 percent. This is only 6% less than the whole of the European Union. If this trend continues apace, China will be a more important market for Brazil than the entirety of the European Union within the next five years.4

Demographics and Internal Demand

Positive demographic trends are a key component of emerging markets’ growth potential and continue to provide a major investment rationale for allocating to these markets. Strong population growth has rapidly increased the number of people of working age in these economies (see Figure 3), bolstered by the rapid urbanization of EM populations. This is in stark contrast to the more developed markets, where populations are aging faster.

This expanding working population and the migration of rural workers into the cash economy in many EMs is also increasing the domestic consumer base (Figure 4), thus setting the stage for private consumption growth that is key as economies make the critical shift from external to internal demand to become self-sustaining. As a result, many emerging markets are expected to become less reliant on exports as domestic demand becomes an increasingly significant growth engine. A BlackRock special report dated March 2010 refers to United Nations estimates suggesting that there are around 1.7 billion people in the emerging economies that earn between US$5,000 to US$20,000 per annum. In terms of consumption, EMs are estimated to have surpassed the US in 2006 (Figure 5) and DMs in 2008, and the potential for further household consumption is impressive.

**Figure 3: EMs’ Working-Age Population Has Exploded**

<table>
<thead>
<tr>
<th>Year</th>
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<th>Developed Markets</th>
</tr>
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<td>3000</td>
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<td>4000</td>
<td>4000</td>
</tr>
<tr>
<td>’10</td>
<td>5000</td>
<td>5000</td>
</tr>
</tbody>
</table>

Source: United Nations, Department of Economic and Social Affairs.

**Figure 4: Asia-Pacific Is Expected to Increasingly Dominate Global Middle-Class Spending**

<table>
<thead>
<tr>
<th>Region</th>
<th>2009</th>
<th>2020</th>
<th>2030</th>
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<tbody>
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<td>North America</td>
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<td>5863</td>
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</tr>
<tr>
<td>Europe</td>
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<td>10301</td>
<td>11337</td>
</tr>
<tr>
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<td>2315</td>
<td>3117</td>
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<td>14798</td>
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<tr>
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<td>1321</td>
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</tr>
<tr>
<td>World</td>
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<td>35046</td>
<td>55680</td>
</tr>
</tbody>
</table>


**Figure 5: EM Consumption Has Eclipsed That of the US**

<table>
<thead>
<tr>
<th>Year</th>
<th>US</th>
<th>Emerging Markets</th>
</tr>
</thead>
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<tr>
<td>’90</td>
<td>28%</td>
<td>28%</td>
</tr>
<tr>
<td>’92</td>
<td>28%</td>
<td>28%</td>
</tr>
<tr>
<td>’94</td>
<td>28%</td>
<td>28%</td>
</tr>
<tr>
<td>’96</td>
<td>28%</td>
<td>28%</td>
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<tr>
<td>’98</td>
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<tr>
<td>’08</td>
<td>36%</td>
<td>36%</td>
</tr>
<tr>
<td>’10</td>
<td>38%</td>
<td>38%</td>
</tr>
</tbody>
</table>

Source: JPMorgan, Data as of January 2011.
Economic Factors
Sovereign debt levels around the world increased dramatically in response to the credit crisis of 2008. Many countries intentionally pushed up their debt levels to fuel the aggressive fiscal and monetary response needed to avoid full-scale economic disaster. But with the worst of the crisis behind us (we hope), it is notable that sovereign debt concerns are mostly a developed market phenomenon (Figure 6). Emerging market debt and deficit levels look benign by comparison—compare Japan’s 220% debt/GDP ratio to India’s, the most debt-laden BRIC country, at 69%. Further, while budget deficits are forecast to diminish globally over the next five years, developed markets should continue to carry more debt than emerging ones.

This balance-sheet strength is due in large part to lower levels of consumer and government leverage. While the banking sectors in the US and Europe have been severely impacted by the subprime debt market collapse, those in emerging markets had very little exposure to this contagion. As a result, EM banks have been generally well capitalized, unencumbered by the lending constraints that remain evident in the developed world.

In addition, household debt levels have been low and the penetration of financial products such as bank accounts is at nascent levels in many markets. Savings rates have also been high. This lays the foundation for growth in credit from relatively low levels, which should provide a boost for emerging economies.

These factors should also support the growing influence of domestic demand by increasing the number of people who can afford a growing range of goods offered at increasingly affordable prices.

Negative Consequences of Convergence
Such a rapid reshaping of the global economy has, of course, brought attendant risks and concerns. Skeptics question the validity of any long-term growth expectations based on trends. Long-term economic convergence has potential limits. Continued growth is not inevitable, and many commentators have discussed the possibility of investor momentum reversing.

The “middle-income trap” describes the range of issues that many countries such as Mexico and Brazil have experienced on its growth path. We believe that low-income economies need to establish better-quality social institutions and infrastructure to cater to the demands of a burgeoning middle class, and this can create higher input costs. Many countries stumble when entering this next stage of growth.

Commodity-rich countries in particular, such as Russia and Brazil, are experiencing considerable difficulties in making the transition to a more industrialized economic position. Commodity markets continue to trade at very elevated prices, causing a decline in manufacturing relative to the production of commodities, and this ‘de–industrialization’ can have a strongly adverse effect on a developing economy’s ability to progress. Conversely, resource constraints, for commodities in particular, are also a concern as an impediment on growth. Competition for energy, in particular, has the power to destabilize not only the global economy but also the global political system.

It is also our opinion that countries focused on production of goods and services—rather than natural resource extraction—are generally more likely to develop the institutional strength and economic openness that seem prerequisites of successful longer-term growth models.

At the same time, it is critical not to overstate the importance of economic growth as a driver of market growth. Valuation, earnings potential and asset class supply all play key roles in prices, and there is compelling evidence to suggest that emerging market valuations have converged with those of developed markets. As a result, emerging markets may no longer provide investors with the levels of diversification that they expected.
Economic protectionist regimes resulting in loose monetary policy imported from the West, combined with the global trade imbalance, have led to economic distortions that continue to fuel inflationary fears. The risk of overheating in emerging economies is rising, and with output gaps at extremely low levels, many fear that this provides fertile ground for another boom-bust cycle. Clearly, prudent monetary policy is crucial if emerging markets are to manage the liquidity waterfall that has flowed from the West. We believe many economies must also support growth in domestic consumption if their economies are to progress beyond a reliance on Western demand that may be on the wane in any event.

EM skeptics also argue that asset valuations are distorted by the yield-suppressing effects of sterilization policies and the second round of quantitative easing (QE2) on the discount rate. Questions remain over what might occur when QE2 ends or emerging market demand for US debt decreases. Asset prices might be overvalued if discount rates are artificially low.

Following such a period of rampant growth, and with rates expected to continue far above those in developed markets, investors need to reappraise their views of emerging markets. Clearly, a range of markets in some 80 countries should not be thought of as a single asset class. At the same time, the drivers of financial returns have been converging in developed and emerging markets. As a result, investors will need to search for new opportunities at the sector or industry level while remaining mindful of a new set of macroeconomic and policy risks.

Section II: China Bulls or Panda Bears?

The Investment Outlook for the World’s Largest Market

There’s a reason why the phrase, “When China sneezes, the world gets a cold” has become such a cliché in recent years. In many ways, it is almost impossible to overstate the importance of the country when talking about emerging markets and, indeed, global markets as a whole. China has been one of the most important engines of global growth over the last 10 years (Figure 7), and there is a widespread belief among many investors that China may be the world’s most indispensible country.

There is an even more prosaic reason why this is important in the emerging market equity universe. A quick review of the weightings of individual countries in the MSCI Emerging Market Index supports this point (Figure 8). The heavy weight of Asian countries (where China is an important customer and driver of growth) and resource-based stock markets (ditto) plus China itself is obvious.

So is it true that as China goes, so goes emerging markets and, by extension, the world? Even a cursory look at some of the high-level statistics points to the overwhelming importance of China on the world stage. From a population perspective, China alone has twice as many people as the United States and European Union combined. Much of this population remains de-industrialized, but that situation is changing quickly as the government encourages urbanization programs. China’s middle class is growing rapidly and should that trend continue, we could soon see an urban middle class larger than any before seen in world history (and larger than the combined urban middle classes of the United States, Europe and Japan). From a broader economic perspective, an analysis from PricewaterhouseCoopers suggests that China will overtake the United States as the world’s largest economy at some point around 2025.
All of this growth, however, comes with a number of risks. China’s current growth rate is likely unsustainable and the Chinese financial system remains deeply troubled. Additionally, China is combating some serious inflation problems, and the economy as a whole is overly reliant on investment spending and nearly uncontrollable credit growth - ingredients that could lead to a financial crisis.

How, then, should investors consider approaching China? In the following pages, we’ll provide some context around the bear and bull cases for the country before outlining some investment conclusions that walk a sort of middle ground between the two. For those readers who are interested in a more detailed analysis of the current state of China (with a particular focus on the Chinese financial system), we would encourage you to read the recently published white paper, *Can China’s Savers Save the World?*, also produced by the BlackRock Investment Institute.

### The Bear Case for China

The bearish case for China begins with the negative aspects of China’s rapid growth rate—including the lack of price signals implicit in managed interest and exchange rates, and inflation. Emerging markets should have higher inflation rates than developed countries if they experience higher growth rates. The clear question given China’s tumultuous history and present levels of income inequality is what constitutes an unacceptably high level. As Figure 9 shows, there has been considerable volatility in inflation series in recent years, giving course to occasional bouts of social unrest.

China is, of course, attempting to tighten policy as part of the government’s effort to reign in inflation. However, it is important to remember that, because of the manner in which the country loosely ties its currency to the US dollar, the government has limited control over its own monetary policy beyond the clumsy tools of administrative controls and expensive sterilization.

Along with the usual problems that inflation can cause in any economy (lowering savings rates, etc.), the Chinese government is particularly concerned about social upheaval. Historically, periods of social turmoil in China have been sparked by mounting price pressures. The rising cost of housing today is a particular concern for many citizens, and Chinese policymakers are deeply worried about potential unrest that rising prices might cause. At the same time, Chinese income inequality has grown (as seen by the rising Gini coefficients in Figure 10 below), highlighting the fact that price pressures have taken on an increased social dimension.

An additional issue that must be addressed when discussing potential risks in China is the country’s overreliance on investment spending as a driver of economic growth. As Figure 11 illustrates, investment growth has surged in recent years, and with investment comprising one-half of the economy, China is now the most investment-intensive country in the history of the world. The data shows that this growth in investment has come primarily from a transfer in income from the household sector—a trend that is unsustainable. Ultimately, such transfers result in a classic “growth trap” and will have to be unwound, in what will be a difficult process for the country. (For additional detail on this point, please see *Can China’s Savers Save the World?*, July 2011.)

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**Figure 9: China’s Inflation Levels Have Been Volatile**

![China’s Inflation Levels Have Been Volatile](source: Bloomberg)

**Figure 10: Chinese Income Inequality Has Been Growing**

![Chinese Income Inequality Has Been Growing](source: University of Manchester Brooks World Poverty Institute/BAML estimates)
So what would this unwinding look like? Our base case sees trend growth slowing towards 7-8% real growth over the next two years, down from the current level of 9-10%. This reflects a number of constraints to growth, including the funding for deposit growth, the declining efficiency of credit expansion in generating economic growth, and some infrastructure bottlenecks including electricity generation capacity. Even if China is able to manage its inflation problem, the case could be made that investment levels in China will have to slow—which could have a negative effect on both Chinese and global growth levels.

Outside of these macroeconomic issues, investors also have to consider some of the governance-related problems inherent in China (the broad issue of governance is covered in Section III of this paper). Because of the centrally controlled nature of much of the Chinese economy, many companies are owned at least in part by the government. Certainly, the interests of the government may not always align with shareholders, which presents some obvious risks when thinking about investments in China. Additionally, from a fixed income perspective, the Chinese bond market suffers from a lack of liquidity and limited investment opportunities for foreigners, which can also make for a challenging investing environment. We do expect a deeper and larger domestic bond market to develop, as well as the much-discussed “dim sum market” for foreign corporate borrowers in RMB. Our confidence here is based on the need to deepen the domestic social security net, and consequential growth in state and private-sector pension provision.

The Bull Case for China
Adopting a bullish view toward China is, first of all, dependent on the belief that the Chinese growth story is not yet at an end. There are certainly risks to China’s growth, but to fully understand where China is going, we first need to appreciate the distance the country has already traveled. Over the last 30 years, China’s GDP has grown at an incredible pace. Figure 12 below compares the relative growth rates of China with the United States. In 1980, Chinese GDP per capita was roughly equivalent to that of the United States in 1790. Since that time, China has effectively
experienced the equivalent of almost 50 years of US growth each decade (meaning that in 1990, Chinese per-capita GDP matched that of the United States in the 1850s, and so on, until 2010 Chinese per-capita GDP reached the US level of the 1940s).

The primary reason for this growth explosion is that in the latter half of the 20th century, China, for the first time, became truly part of the international community, gaining access to new capital sources and new ideas. A consequence of this openness was massive capital inflows that took advantage of relatively inexpensive Chinese labor costs, and hence, rapid economic growth. There is an argument to be made that these trends are still accelerating. Despite some strong industrialization in China and dwindling growth in the demographic dividend over the next decade, at least 40% of the country’s population is still focused on agriculture, suggesting that there remains a large potential labor pool that could make a meaningful contribution to the Chinese economy.

But what about the argument that the Chinese economy is suffering from financial imbalances? To at least some extent, a China bull would point out that the quality of the official data overstates the importance of investment in China. There has been a great deal of academic research on this topic (see, for example, The Size and Distribution of Hidden Household Income in China by Xiaolu Wang and Wing Thye Woo, December 2010, Chinese Research Society for Economic System Reform), and our own assessment is that official statistics understate the actual amount of consumption in the Chinese economy by close to $1 trillion. Official numbers that measure such factors as consumption of household goods, automobiles and housing seem to drastically undercount what is really happening, and personal income levels also appear significantly higher than what is actually reported. As a result, one could make the case that the investment-related component of Chinese GDP is significantly lower than what is suggested by the official data.

This brings us to a discussion about Chinese inflation. Inflation in the high single digits is not unheard of for emerging markets, especially in markets where growth levels have been so high. One part of the Balassa-Samuelson Effect is that service-sector inflation is less flexible than that of tradable goods. Thus, as an economy becomes richer, it develops a service sector and this sector bids up for labor. In China, given the under-recording of service-sector activity, it is unsurprising to learn that inflation is rather higher than official levels. This should continue to be the case in the future as China seeks to raise minimum wages and thereby transfer savings from the corporate to the household sector as part of a policy to rebalance the economy from investment to consumption.

The primary worry for policymakers is employment. Chinese authorities are highly focused on making sure that the country’s 1.3 billion citizens are employed as part of their strategy to ensure that their political system can be maintained. Certainly, China has been tightening policy in response to higher inflation, but we believe that managing inflation (and overall economic growth, for that matter) is a secondary concern for the government.

Finally, from an investment perspective, the bullish observer would point out that while there certainly are governance problems in China, emerging markets hardly have a monopoly on bad governance—and, as will be discussed later in this paper, it is far from clear how important political or corporate governance is in determining asset returns. From a more fundamental perspective, if one chooses to believe that relatively high levels of Chinese growth can be sustained, assets should benefit from a higher growth differential.

Economic and Investment Considerations
So given these competing backdrops, how should investors consider approaching the China question? There are some complicated factors at work, and even within BlackRock, we do not have a single “house view” on this question. We can, though, offer some high-level thoughts.

In general, we lean toward the bullish side of the debate. We are concerned about financial imbalances in China and view this issue as perhaps the key downside risk, but we do not see the overall political backdrop in China as being a serious impediment to growth.

From a broad economic perspective, we think that Chinese growth will slow in the coming years, at least in part due to the financial problems we described, but we are far from calling for any sort of outright collapse or financial crisis. Chinese growth is unlikely to remain at the near-10% level it has recently enjoyed, but we would anticipate it slowing to somewhere around the 8% or 7% level rather than approaching any sort of recessionary environment.

The investment story in China is mixed as well, but as with our view of the Chinese economy, we would lean more toward bullish than bearish. Governance risks are likely overstated, in our view, and we believe both the macro environment and fundamental factors suggest that value can be found in Chinese assets. There are certainly risks, and we would advise investors to proceed with caution, but we also believe that China is, and will remain, one of the most important and compelling investment regions in the world.
Section III: Governance Matters

Long-term stability and credibility of governance is of great importance for the development of asset markets, attracting capital and foreign direct investment. A strong legal framework should include corporate law, securities law and the necessary infrastructure for enforcement. In addition, credible fiscal, financial and central bank structures, along with transparency and governance accountability, are vital for ease of investment transactions and investor confidence, and are key components of valuations.

If investors do not fully believe that a particular country’s central bank and ministry of finance will act appropriately to maintain stability in the economy and financial system, and will “do the right thing,” or if they are not comfortable with the legal and financial systems in place, they will want to be rewarded for the greater levels of perceived risk. The fact that emerging market equity valuations have converged with those of developed markets, or in some cases trade at a premium, suggests investors believe risks have at least somewhat abated.

It is difficult to generalize when looking at issues of political governance—similar to the corporate level, a nation’s political environment must be viewed on a case-by-case basis. Each economy, be it emerging or developed, is distinguished by its own unique macroeconomic, social, geographic and political features. Therefore, while it is possible to compare basic macro indicators across nations and draw some relative value conclusions, countries often have different political agendas and priorities behind the numbers. For example, the Chinese army is the largest employer in the world, the largest employer in the United States is the federal government and the largest employer in Europe is the UK’s National Health Service—and these public employers all distort labor, activity, government expenditure and household income data.

The accuracy of statistics available for comparison also varies widely. Analysis between countries can often be difficult or even misleading, as it usually depends on the accuracy and accounting methodology of official statistics. Calculating national accounts is complicated in the best of times, and official data for countries such as the UK, Germany or the US is usually subject to numerous revisions. For countries with enormous populations — such as China or India, which have in excess of one billion inhabitants apiece — accurately gathering and interpreting data is therefore a mammoth task, even without political interference (as discussed in the previous section).

Emerging Markets Have Made Tremendous Progress

During the 1990s, a wave of reforms was implemented in many emerging economies in line with the so-called “Washington Consensus,” which encompassed ideas about liberalization, privatization and fiscal discipline. Latin America undertook the most comprehensive reform, particularly in trade liberalization, but reforms were also implemented in parts of Asia and Africa. Since then, however, the subsequent growth rates of many of these restructured economies have significantly underperformed those of other developing nations such as China and India.

The comparison with China is particularly pertinent when looking at issues of political governance, because, although it has become more market orientated, it did not follow a similar path to direct privatization and liberalization as those reforming Latin American nations or of developed economies such as the United States or the United Kingdom. The Chinese economy has grown rapidly and undertaken several reforms over the last decade, and yet it has to a large extent retained its planned-economy framework and has only partially adopted aspects of the consensus—for example, by dropping trade barriers in special designated economic zones. This reinforces the idea there is not one correct route for political governance, but that stability and credibility are critical to market development.

Over the last decade or so, emerging markets have generally continued to catch up with governance standards in the developed world, and many countries continue to make strides forward. As one example, in Russia many state-owned assets were at least partially privatized after the dissolution of the USSR in the 1990s, where private enterprises were previously difficult to come by, although the outcome of these sales has been controversial. More recently, Russian President Medvedev announced that stakes in some of the country’s largest state-owned companies would be sold and state officials have been ordered to step down from the boards of state-owned companies. In Malaysia, the Securities Commission’s Corporate Governance Blueprint 2011 included proposals to improve the country’s governance framework over five years. In Brazil, companies that choose to list on the Novo Mercado section of the Bovespa voluntarily sign up to a set of stricter corporate governance rules than those that are currently legislated for.

Of course, there are also places where governance has not improved—take, for example, the re-nationalization of pension funds in Hungary, as well as reforms in Korea that have been resisted by the chaebol. In many developed markets as well, governments have become deeply involved in individual banks
and the banking sector as a whole as a result of the financial crisis. It is quite likely, in our view, that the trend to increase regulation in developed markets will coincide with deregulation in many emerging markets.

Political Risk Converges
The political, investment and market landscapes in developed economies have undergone significant changes over the last few years. It could even be said that 2008 redefined notions of risk in the global economy. Prior to the financial crisis, few could have imagined that there would be quasi-nationalization programs and forced mergers in the banking systems of many developed economies. Furthermore, observers would not have expected to see such pressure from politicians on independent central banks to act in a particular way. Sovereign debt problems in the eurozone periphery pose a substantial risk to financial markets, banks and economic growth in many developed economies. The potential ramifications of the Greek crisis not being resolved are extremely worrying.

In contrast, the credibility of numerous EM governments and central banks has improved dramatically over the past 20–30 years. Starting with fiscal policy, many EM economies pursued fiscal tightening measures even during down cycles, which enhanced credibility with foreign investors. This helped lead to a flow of capital into emerging markets as investors became more confident. It is important to note that credibility does not necessarily mean Western-style democracy, but rather the track record and political will to act in a responsible manner. For that, a strong, cohesive society and government may be more important.

Market performance shows that, overall, investors do put weight on political intervention risk when making investment decisions (Figure 13). Where governments have lost credibility, their economies have been punished by investors. One extreme example is the caution demonstrated by foreign investors in Russia after that country’s default in 1998. At a sector level, Chinese banking stocks have systematically underperformed the broader market in recent months, despite the country’s robust economic growth, and the banks’ credit default swaps have also widened due to concerns relating to government interference. Investor caution towards this sector is based on concerns that banks will be impelled to act in certain politically motivated ways by authorities that are not beneficial for financial returns.

Fears about political continuity and upheaval have generally declined in emerging markets over the past two or three decades, although pockets of concern remain. Regime change often leads to investor uncertainty or risk aversion. The turmoil of the “Arab Spring” in the Middle East has impacted some frontier markets, and conflicts continue in places like Libya, Syria and Yemen. Out of the many elections this year, the one in Russia is most likely to attract attention as Vladimir Putin and President Medvedev jostle for position, while in Peru the stock market fell by more than 10 percent following the election of a new government and an anticipation of populist tax increases falling on the natural resources sector.

The risks of government interference are higher in state-controlled companies, regardless of their domicile, because of this issue of command and control. In addition, when considering corporate investment, we think certain sectors should be treated cautiously towards this sector is based on concerns that banks will be forced towards this sector is based on concerns that banks will be forced to interfere in banks, energy, commodity and monopolistic markets. Further, governments are targeting specific industries with penalties, such as mining taxes in Australia, or the shutdown of the nuclear industry in Germany.

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**Figure 13: Countries With High Governance Rankings Have Tended Toward Lower Volatility**

<table>
<thead>
<tr>
<th>Country</th>
<th>Standard Deviations of Monthly Returns</th>
</tr>
</thead>
<tbody>
<tr>
<td>China</td>
<td>18%</td>
</tr>
<tr>
<td>Russia</td>
<td>15%</td>
</tr>
<tr>
<td>Poland</td>
<td>12%</td>
</tr>
<tr>
<td>Brazil</td>
<td>11%</td>
</tr>
<tr>
<td>Turkey</td>
<td>9%</td>
</tr>
<tr>
<td>Hungary</td>
<td>6%</td>
</tr>
<tr>
<td>Malaysia</td>
<td>3%</td>
</tr>
<tr>
<td>Indonesia</td>
<td>1%</td>
</tr>
<tr>
<td>S. Korea</td>
<td>0%</td>
</tr>
</tbody>
</table>

Source: Datastream, UBS.
In the end, we can simply fall back on market judgment. We can see from examining the Emerging Markets Bond Index spread that emerging market sovereign risk has fallen significantly over the last decade, notwithstanding the sharp spike during the financial crisis (Figure 14).

Corporate Governance

Corporate governance can play a key role in valuation and investment risk, as well as in the long-term performance of stocks and credits. The term is an umbrella that covers many issues, including timely accounts, transparency with investors, a legitimate board and growth plan, and the competent management of business operations. Ten years ago, most investors would have expected the management of emerging market companies to be worse than those of developed markets in terms of returns to shareholders. In recent years, however, there has been a great deal of convergence, and standards in certain areas of DMs have even fallen while EMs have improved. Standards of governance significantly improved in emerging markets as capital started to be more liberally deployed across the globe, and with less of a regional or home-country bias, as investors sought new opportunities for alpha or yield.

Russia is often cited as an example of poor corporate governance in the past negatively affecting investor sentiment. Limited confidence in standards of corporate governance means that valuations are low overall (although some consumer sectors have higher valuations), and Russian equities trade at a significant discount to peer companies elsewhere. The Russian economy experienced a severe financial crisis in 2008, and valuations present in valuations—reflecting limited supply, in part—the case for EM debt as a growing and important asset class is hard to disprove.

Figure 14: EM Sovereign Risk Has Decreased

![Graph showing EM Sovereign Risk Has Decreased](source: JP Morgan Emerging Market Bond Index)

BlackRock’s Sovereign Risk Index, debuting earlier this year via the BlackRock Investment Institute (*Introducing the BlackRock Sovereign Risk Index: A More Comprehensive View of Credit Quality*, June 2011), tends to rate emerging markets reasonably highly despite lower GDP per capita levels (and thus debt sustainability), and weaker regulatory institutions and credit histories (Figure 15). While we would agree that some irrational exuberance is
widened against the MSCI World. Despite some strong macro fundamentals, weak investor sentiment means that this discount has not yet narrowed again. Even some of Russia’s natural resources companies tend to trade at a large discount, while their Brazilian equivalents trade at similar levels to their developed market peers. To resolve this problem, the Russian government is now making strides towards improving the image of Russian corporates and the country is likely to join the World Trade Organization (WTO) in the next 12 months or so. In recent months, there have been numerous positive political statements both from within Russia and externally on that issue. It should be noted that China’s accession to WTO membership in December 2001 set off a decade-long process of strengthening institutions in that country.

Standards of corporate governance can have a significant impact on stock performance, and there are numerous high-profile examples of companies whose poor accounting practices have been exposed, causing their share prices to plummet (such as Sino-Forest). As they grow and become more international, companies based in emerging markets increasingly recognize the importance of investor sentiment for valuations and investment demand. Governments also recognize the need for strong corporate governance standards, because individual corporate corruption cases often have ramifications on a much broader scale.

From a relative-return perspective, risk appetite can significantly impact the performance of stocks that are seen as having good or bad governance. In a risk-averse environment, good corporate governance is extremely beneficial, and those stocks are rewarded by investor demand. Conversely, in a bullish market, stocks with poor governance tend to rise with the market, and this high beta often causes them to outperform. For investment purposes, in terms of potential changes to valuations, it is important to look at the status quo in corporate and political governance, but also to see where these conditions are changing, for better or worse.

Governance is a key component in valuations and we believe that, motivated by the demand for capital and investment, the numerous fundamental improvements that have so far occurred in EM corporate and political governance are here to stay. We believe that good governance is critical, and BlackRock as a firm devotes significant resources to actively monitoring corporate governance and political developments in these markets.

Section IV: Macro vs. Micro

When choosing where to allocate investments, macroeconomic conditions remain of vital importance. When approximately 50 senior BlackRock investors were surveyed recently on what they saw as the main risks for emerging market investing, macroeconomics was the area cited by the overwhelming majority of respondents.

Thus, we view the macroeconomics of emerging markets as being of great importance and continue to pay this area a significant amount of attention. However, we also believe that there are fewer diversification benefits from allocating to EMs per se than there were several years ago, given economic and valuation convergence, and it is important to consider both macro and micro perspectives when making investment decisions. By managing the macro risks but using fundamental methods to select underlying stocks, fund managers can identify opportunities to achieve alpha as well as beta.

At the Macro Level

As noted above and discussed in greater detail in the next section of this paper, high levels of inflation remain a significant source of risk for emerging markets, particularly when we consider the output gap in many of these countries to be very low. This means that if economic growth in economies such as China and India remains robust, inflation is more likely to pick up than subside. In addition, with the exception of countries such as Brazil, real interest rates are at very low levels and monetary policy is extremely loose. One of the main concerns constantly referenced by market commentators is the need for China to engineer a “soft” landing. However, addressing inflationary issues may lead to concerns about the impact of higher real rates on growth and consumption, and the possibility of a “hard” landing. Structural issues may also grow in importance and potentially create macro confusion as the major emerging markets transition over the next five years to become more important players in the global economy. These countries must also try to avoid the middle-income trap and develop an economy with a middle class that is self-sustaining—an issue that we will examine in greater detail later in this paper.
Inflation Risks and Yield

One specific challenge that is beyond the realm of monetary policy is the speed with which commodity price inflation transfers to consumer and producer price inflation in low- to middle-income economies (Figure 16 above). This speed is a result of the relatively high weightings of basic foodstuffs and energy in consumer baskets in these countries. It seems reasonable to expect that commodity inflation will remain a source of macroeconomic volatility for some time to come in these economies (Figure 16). This suggests the need and likelihood of stronger currencies as governments move away from pegged rates towards free float to combat imported inflation risk.

Conversely, the current bull run in emerging markets could continue and China might be able to engineer a soft landing (which, given savings rates and the semi-closed capital account, remains our central case). As discussed earlier, success on a macro level for China is not the same as it may be in other parts of the world—for China and its population of more than 1.3 billion people, creating employment and keeping social unrest at bay is the number-one goal; the performance of the country’s equity market is far less important. Meanwhile, the developed world is experiencing turgid growth and has its own problems, not least sovereign debt and banking risk. The medium-term outlook for developed markets—one of generally lower nominal growth than emerging markets—suggests that rates will remain lower in DM countries than EM. This thereby supports the view that emerging debt markets offer attractive investment opportunities for investors seeking yield.

Convergence of Markets

At the same time, the recent financial crisis and other recent market-moving events have demonstrated that, from a beta or overall index perspective, developed market and emerging market equities are now highly correlated (Figures 17 and 18)—although correlations differ for specific markets and are not stable through time.
As the financial crisis took hold, both emerging and developed equity markets fell, and when developed market bonds fell, so did those from emerging markets. The correlation between emerging and developed market equities was around 0.7 as of June 30, 2011.

Even though large macro differences remain, and despite the fact that emerging markets are, in general, still more cyclical than their developed counterparts, it can no longer be said that emerging markets per se are pure portfolio diversifiers. Rather, as EMs have developed over the last decade, investors now must look to the micro level for genuine sources of portfolio diversification and outperformance compared to both emerging and developed market indices. Indeed, in this regard, EMs have come to more closely resemble their DM counterparts—and, as a result, investors in these markets must now balance macro and micro considerations.

The gradual homogenization of emerging and developed market equities has also slowly reduced one of the key sources of return that EM investors would have expected to benefit from in past years. A decade ago, after the 1994-2002 EM crisis, EM equities were trading at big discounts to DMs, but valuations and share-price multiples have now converged to such an extent that emerging market investors can no longer simply rely on improvements in valuations to provide a compelling return. Drilling down to the micro level and distinguishing between different sectors and companies within an EM allocation is of greater importance now that this general support for emerging market allocations has effectively dissipated, or at least provides less opportunity for further generic improvements in valuations going forward.

Differentiation Between Economies and Stock Markets

Economies are not necessarily stock markets. Although it might seem axiomatic that more rapidly growing economies would produce correspondingly higher real equity returns, on aggregate, than economies advancing at a slower pace, historical data has largely shown this not to be the case (Figure 19).

One extreme example within the emerging market space that highlights the potential disparity between economic growth and the performance of risk assets is that of the Chinese stock market. In China, the rate of GDP growth has consistently been among the strongest in the world (10% per year annualized over 10 years) but, despite this, the Chinese stock market has not significantly outperformed that of Hungary, which has been one of the slowest-growing economies (approximately 2% growth per year annualized over 10 years). Over that same decade, the MSCI China returned 14%, while the MSCI Hungary returned 13% (Figure 20).
In particular, despite the robust Chinese economic growth and expansion of its financial sector, the country’s banking sector has lagged that of other domestic sectors and banking stocks globally. To us, this suggests that investors in emerging markets have proven themselves to be as selective in their stock and sector exposure as they would be in developed markets, if not more so.

This dispersion is also a consequence of stakeholder dilution, which is a feature of faster-growing economies. Consider the following stylized example, where a stock market is represented by companies A and B of equal size, and the investor holds 50% in each company. The investor, in this case, holds 50% of the overall market. Then Company C lists with a similar size as each of A and B. Unless the investor subscribes a further 50% of Company C, his stake in the market is diluted (on a zero subscription basis to 33.3%).

In a perfect world, the investor would subscribe to maintain his stake. The real world, however, is more complicated. New listings often have limited shares available and may be unattractive on valuation or timing grounds. It is more rather than less likely that investors’ stakes in whole markets are diluted by this process.

More prosaically, EM economies tend to have underdeveloped corporate bond markets (India and South Africa being notable exceptions), making it attractive for companies raising capital to opt for longer-duration equity funding rather than bank finance. As such, earnings per share often lag sales per share in fast-growing economies and dilute overall market returns.

So, from an equity perspective, what is critical is to find companies, not countries, within the emerging market space that can grow earnings at sustainable rates over time. We are extremely skeptical of arguments that overly rely on EM growth rates to justify expected rates of return. That said, while rapid rates of GDP growth do not directly lead to equity market outperformance, recession and GDP contraction constitute a major headwind for equity markets—and one that is difficult for single companies to overcome.

Good Security Selection Is Key

Corporate selectivity is important because, at the micro level, there are huge dispersions within EM asset markets between the quality of companies and the valuations of their associated stocks, bonds and convertibles—perhaps even more so than in many developed economies. Some of the factors behind this include the institutional, regulatory and financial system frameworks, as well as issues relating to corporate governance, investor accessibility and limited track records.

Returns on equity (ROEs) in emerging markets have structurally improved and exceeded developed markets every year since 2001 (Figure 21). A number of factors are important in terms of fundamentals and stock selection: demand and supply technicals, the availability of local investor bases and their capital structure positions, as well as macro factors such as demographics. We believe that there is a wide variety of investment opportunities but that good security selection is vital for active returns.

![Figure 21: MSCI EM Has Outperformed MSCI World](source: Morgan Stanley)

EM companies have come a long way from both a fundamental performance perspective and in corporate governance. However, we think that some of the metrics purportedly illustrating the “quality” of companies, such as higher ROEs, are in some cases misleading, where they may have more to do with a lack of competition than with dramatic outperformance in a truly free and competitive marketplace. Moreover, one of the factors that can substantially impede competition is financial sector underdevelopment, since if small and medium-sized businesses are prevented from gaining access to capital, they of course cannot effectively erode the margins of a monopoly or an oligopoly, or compete.

In addition, when investing across the capital structure, a great deal of care must be taken to guard against poor management capital allocation decision making. In many cases, capital allocation may reflect local priorities rather than consideration for the interests of existing investors.

One of the key criteria in selecting emerging market companies, from an equity investor point of view, is to identify those firms that can sustainably grow their wealth per share over the longer
term, as well as to consider whether margins and valuations can be sustained. Of course, as seen in the previous section of this paper, issues of corporate governance (and potential improvements therein) may play an important role in the long-term outlook for companies. In addition, factors such as currency, liquidity and the depth of markets will be factored into the stock selection process.

Valuations matter—just as in developed markets, they carry limited information about nearer-term returns but a great deal about longer-term rates of return. In general—though not always—sectors and stocks in fashion can command premium ratings to peer companies in developed markets as investors chase growth. This has been evident in the Internet and social networking boom recently, as an example. Early identification of winners and long holding periods seem to be the message. Therefore, a good understanding of the micro-level dynamics and a view on the performance and direction of individual assets and sector or market-wide issues will play an important role in the total performance of an investment.

At the micro level, implementing an EM investment idea can be handled directly, via long positions in fixed income, equities, exchange-traded funds (ETFs) and real assets, or indirectly through exposure to an international company headquartered in a developed market but with a large business in emerging markets. Some high-quality companies listed on DM stock exchanges with sizeable levels of business in EMs are currently trading on cheaper valuations than local EM stocks. Global luxury brands, for example, have performed strongly over the last couple of years and yet are valued at a discount to some domestic EM consumer stocks. Accessibility may be one issue here—the emerging market domestic consumption story has been a theme for several years and too much money seeking exposure to a few domestic assets may have led to some overvaluation. Instances such as this highlight the opportunities available for unconstrained portfolio managers to obtain a better value exposure or to create alpha through arbitrage.

The market capitalizations of countries such as China are likely to increase as these economies continue to grow and, given the binary nature of growth between emerging markets, spearheaded by China and India, and developed markets, the size of EMs as a component of global risk asset indices should therefore increase over time. Today, despite the huge advances enjoyed by emerging markets, their entire combined index weight in the MSCI All Country World index is just 13.8%, as of July 15, 2011 (Figure 22). China is only 2.4% of the index, less even than Switzerland at 3.3%, while the UK and US comprise 8.3% and 43.2%, respectively.

One consequence (as referenced previously and discussed in greater detail later in this paper), is that a great deal of money has been chasing relatively few assets within particular segments of emerging markets. As their market caps grow, however, so too should the liquidity and the depth of these markets. This is important, because the infrastructure and accessibility of markets will determine where fund managers can invest, as well as the transaction costs and price elasticity. At present, there is a shortage of high-quality fixed income product in emerging markets in terms of debt issuance, and we believe that situation should improve. Again, as markets grow and the investment set expands, investors in search of alpha need to be equipped to identify which companies have the greatest potential to become strong, successful brands and may even go on to become international companies, and those which may fail to make that transition. Investing in these markets to achieve active returns is, therefore, not simply a question of selecting an index that may deliver beta, but rather of closely examining individual companies and their securities.

Just as there are clear macroeconomic, cultural, geographic and political differences between individual emerging market and developed market economies, so too are there significant differences at a sector and corporate level. While it is therefore possible to draw some conclusions about relative value levels on a national or index-level basis, it is extremely difficult to generalize across such a broad universe as “emerging” or “developed” markets. Instead, there is a sense that the investment world is now at a stage where a key factor in achieving excess returns is the ability to take a global, cross-border approach to asset allocation. In our view, entrusting allocation decisions and implementation to an experienced portfolio manager is therefore crucial for returns, because that manager can perform in-depth analysis of the different investment opportunities, and adjust sector and stock-specific decisions as market conditions evolve and news flow unfolds.
Section V: Framing the Challenge of Inflation in Emerging Markets

As touched upon in previous sections of this paper, a key risk facing developing economies is the challenge posed by inflation. Across emerging markets, real yields are negative, and indicators like the Taylor Rule suggest that policy rates are too loose (Figures 23–25). Credit growth has also been vigorous in many countries. The implication is that above-trend inflation is a real risk for some emerging markets.

The appropriate policy response in this situation is typically to raise interest rates. As it turns out, this is difficult in a world of competing goals held by different policy-makers. The upshot is likely to be a secular rise in the value of EM currencies, in order to avoid an inflationary spiral or an economic collapse.

The EM Trilemma

It is not yet clear that inflation is an imminent problem in EMs, especially given these countries’ exposure to weak DM growth and the fact that some of the inflation is driven by potentially transient factors like commodities, rather than more persistent demand-driven inflation. However, many EM countries recognize the potential for inflationary pressures in their economies—if not now, then in the near future. Several high-profile protests and public grievances have highlighted concerns over inflation, and many countries, including Turkey and China, are attempting to limit money and credit growth using tools like reserve requirement hikes. Some central banks have even raised rates modestly in recognition, including India in 2011.

Unfortunately, raising rates to combat inflation conflicts with other policy-makers’ goals, which means that EMs face some difficult choices. A good way to illustrate the difficulty EM countries face in raising rates is to frame their choices using a concept know in economic theory as the Trilemma, or the Impossible Trinity. The Trilemma suggests that it is not possible to simultaneously maintain a fixed exchange rate, free capital flows and interest rates.

To understand the Trilemma, consider the following stylized narrative of a major EM country in the post-crisis world. In the face of incipient price pressures, this country may wish to raise...
interest rates in order to manage inflation rates in its domestic economy. Assuming that developed market countries keep their rates static, the relative interest rate differential between EM and DM rises. This increase makes it attractive for investors to send capital flowing into the EM country to earn the higher rate of return—capital that is perhaps borrowed in the DM and lent to the EM in a “carry trade”. This flow of capital can occur because the EM does not maintain restrictions on the movement of capital.

Capital flows from the DM to EM inherently mean that the DM country’s currency is being sold in exchange for EM currency, since that is the currency in which the higher EM deposit rate can be earned. The EM currency may already be under upward pressure because of a current account surplus: DMs buy more goods (such as oil or manufactured items) than they sell to EMs, and in doing so increase the global supply of DM currency relative to EM currency. If interest rates in DMs are also moving down at the same time because of policy actions like quantitative easing, EM currencies will be further in demand.

The EM currency, which is now scarcer because of increased demand, begins to appreciate. This appreciation can make EM exports less price-competitive in global goods markets. To the extent that a stronger currency goes against the export-led industrial policy of the EM country and its domestic producers—who may have encouraged the establishment of a peg to DM currency values—the country can try to “sterilize” the negative effects of an appreciating currency by acquiring the incoming flow of capital in the form of FX reserves. This has the effect of reducing the amount of DM currency flooding the market and therefore helps limit EM appreciation.

Unfortunately, amassing FX reserves and taking DM currency off the market is risky and potentially inflationary. FX reserves are an asset on the balance sheet of the EM country’s central bank. As with all assets, FX reserves will need to have an offsetting liability. Unless the central bank sterilizes the newly accumulated FX reserves by selling an equivalent amount of another asset on its balance sheet, it will have to fund the FX reserves by issuing a new liability—printed money, bank reserves and discount bills are common forms of central bank liabilities, and all of them serve to increase the money supply in the EM country. Growth rates of money supply well above nominal GDP on a sustained basis signal either increased monetization rates (often a feature of these economies) or asset price inflation and increasing credit risk, leading to asset price-led inflation and the need for a market-unfriendly policy response (Figure 26).

The end result is stark — despite its efforts, because it simultaneously tried to maintain a stable fixed exchange rate and open capital flows, the EM country was unable to control inflationary pressures in its economy. The decision it faces is to control capital flows or lose control over inflation. Or do neither and let its currency appreciate.

The Trilemma can be used to reconfigure this narrative in a variety of different ways. For example, it can account for countries that may wish to lower rates in response to a demand shock in their domestic economies. If they do so while maintaining a peg and an open capital account, they will eventually suffer capital flight leading to currency devaluation pressures. For some period of time, the central bank may attempt to defend the value of the currency by buying it in the open market using FX reserves. When those reserves are exhausted, as was the case with the United Kingdom’s sterling crisis in 1992, the country has to choose which policy it will abandon.

In the short term, the Trilemma can be avoided—FX reserves are an example of pushing the problem down the road. Asymmetric capital controls—making it much easier to export capital than import it—are another tool. But these mitigants often break down in the medium term. FX reserve accumulation risks capital loss if the foreign currency eventually devalues, deflates or defaults. Capital control asymmetries suffer from gradual erosion, as discussed below.
The EM Reaction Function
To date, EM economies have responded to these competing policy goals in various ways. Some countries like Brazil and India have semi-free capital flow regimes and independent monetary policy, thus relinquishing control over their exchange rates. Another popular approach is to keep both currency pegs and capital controls, while allowing domestic policy (specifically, monetary policy) to be effectively set by a country’s major trading partners.

FX reserve accumulation is one way to combat capital flows without allowing one’s currency to appreciate. Indeed, there are grounds for believing that this is exactly what many EM countries have been doing.

Capital controls and FX reserve accumulation have a special place in recent EM international economic history. One of the risks that EM countries have historically faced is massive capital flight when global liquidity unwinds. Capital flight can be extremely destabilizing for countries—consider, for example, the events of 1997–98 in Asia, where dramatic capital flows caused severe disruptions in the operation of currency regimes. In that sense, seeking to limit exchange rate fluctuation through the amassing of FX reserves seems like a reasonable policy. Perversely, however, FX reserves can only be built up by selling products without converting the proceeds of those sales into consumption. This creates a structural demand for reserve currency (typically, the dollar), which allows the reserve currency issuer to run a current account deficit for an extended period of time. The US accomplished this without seeing the normal currency devaluation of the dollar and increase in inflation (and, consequently, interest rates) that accompanies a persistent current account deficit. Some economists argue that the competitive exchange-rate policy of some EMs that led to FX reserve accumulation is responsible for the build-up of global imbalances that began to unwind violently in 2007–2009.

If FX reserve accumulation presents only a limited reprieve from the logic of the Trilemma, capital controls may also suffer from shortcomings. Destabilizing capital movements can be combated with controls, but there is evidence that they may be eroded over time. In addition, some economists argue that for a country to begin improving its investment efficiency and increase the international use of its currency, capital account convertibility must exist.

If capital flows are not or cannot be controlled, the alternative is to either de-peg a currency or lose control of domestic monetary policy. Faced with the choice between a lower point on the growth continuum or the negative social effects of non-linear inflation, EMs are likely to eventually allow currency appreciation. Exchange rate appreciation is not without its risks—rising rates hurt confidence, make debt (and the assets it supports) harder to service, reduces hiring and investment, and can expose mal-investment from the boom years. For these reasons, there is speculation about a hard landing in some countries. However, the costs of gradual currency appreciation are likely less than those of austere capital controls and lack of domestic policy control.

One final observation: excessive accumulation of foreign exchange reserves distorts economic incentives and creates financial risk. A pegged or semi-pegged exchange rate subsidizes exports and investment (as export industries are generally more capital intensive than domestically facing businesses). Accumulation of FX reserves involves the exchange of goods and services output for paper promises issued by heavily indebted nations (HINs). The depth of US dollar and Euro debt markets means that world FX reserves are dominated by these two currencies—hardly reassuring news in the midst of the Great Fiscal Crisis. While FX reserve accumulators can claim that they would only suffer paper losses in the event of allowing their currencies to float up sharply against those of HINs, such a move could create considerable instability across the globe given the sizes of reserves to GDP in several cases.

Section VI: Potential Limits to Emerging Markets Growth
The preceding sections have outlined the remarkable transformation of emerging markets economies over the past few decades, illustrated most dramatically, perhaps, by the rising importance of China in the global economy. We have also explored some of the key risks that investors need to consider in evaluating these markets—including political and corporate governance risk, inflation risk and the declining diversification benefit of EM vs. DM investing. Now we examine some additional potential constraints and limits to growth in emerging market economies.

Risks to a Narrative of Unfettered Growth: Natural Resource Constraints
While the risks surrounding the need to rebalance macroeconomic disequilibrium (as detailed previously) are perhaps most prominent in the minds of many investors, another oft-cited argument involves the relative scarcity of natural resources demanded for industrial and economic development. This argument contends that as large EM economies undergo rapid growth, the pressure on commodity availability, as well as the

increased pricing pressure due to this significant added demand, will act as a meaningful constraint to growth. Certainly, at one level the argument appears to have merit, as commodity price spikes in 2008 and in late-2010/early-2011 indeed appeared to threaten global growth rates, consumer spending and macroeconomic stability.

Indeed, as the financial crisis and subsequent recession transitioned to recovery, we saw primary energy demand from non-OECD (Organization for Economic Cooperation and Development) countries outstrip that of OECD (a proxy for DM) countries for the first time, illustrating rapidly increasing EM industrial production and consumption.

Still, we are generally skeptical of this argument over longer time horizons, while recognizing that there may be shorter-term impacts. In general, we think it is difficult to identify any period in history when an industrializing country or a group of industrializing countries (which have always been highly dependent on natural resources and energy requirements) experienced a genuine and sustained impediment to growth from natural resource scarcity. The environment may be different this time, but we think there is always a danger in merely extrapolating recent trends.

We would argue that many dynamics beyond organically derived supply and demand elements factor into commodity prices, such as dollar-debasement, as well as some degree of financial speculation. While we would suggest that natural resource scarcity (or short-term price hikes) do not, in themselves, present a risk to EM growth in aggregate, we do think country- and company-specific differentiation needs to be carefully taken into account when considering the risk of severe commodity price declines. Specifically, certain countries, such as Russia, Mexico, Chile and South Africa, would potentially see economic volatility rise if there were a catastrophic fall in energy sector prices, so one must pay close attention to how levered an economy (or company) is to a given commodity price level. Added to this, high commodity price levels can also result in perverse economic decision making from a development perspective, and indeed, we have seen countries like Brazil focus more on natural resource extractive industries in recent years, and in effect de-industrialize their economies to a degree.

While resource availability in general may not be a constraint on growth, limitations on the supply of some key inputs arising from the social need to deliver key services at price levels that are socially acceptable but may discourage effective investment can place barriers on growth. Principal among these would be water and electricity supply. Water shortages arising form mal-investment and an inability to earn a reasonable rate of return on investment represent a particular risk in Asian food production, as 75% of Asian fresh water supplies are employed in agriculture. Electricity supply constraints arising from prices that are too low to recover investment has been a feature holding back growth in South Africa, China and India, among other areas.

Risks to a Narrative of Unfettered Growth: The Middle-Income Trap

While in aggregate EM economies have maintained an economic growth trajectory roughly three times the rate of that found in DM economies—skewed, to be fair, towards Asia and, more latterly, Africa—economists have also increasingly taken note of the tendency of individual EM countries to experience slowdowns in growth as their economies get larger and more complex, and as living standards rise. This phenomenon, though still little understood, has been referred to as the “middle-income trap,” whereby countries that transition from lower-income status (with high levels of poverty, poor infrastructure, weak governing institutions, etc.) to a middle-income group, where many of these problems have been resolved and per-capita incomes have increased markedly, nevertheless find it extraordinarily difficult to move to high-income DM status. As Singapore, South Korea, Taiwan and Hong Kong have shown over the past few decades, while it is possible to make the leap from lower-income to higher, it is clearly not easy, and many countries seem to continually fail at the transition.

It seems to us to be no accident that all four of the “winners” mentioned above possess similar characteristics. All four are open economies with a high share of trade to GDP. As a consequence, all have highly developed banking systems. They all have world-leader positions in highly sophisticated manufacturing or service industries. They are characterized by high savings rates, government-sponsored planning backing key industries, and first-class physical infrastructures. Institutional strength is high in all four cases, as are educational standards and the rule of law. While none of these factors in itself guarantees success, it is hard to imagine countries that fail to meet most of these criteria being able to break through the middle-income trap.

Brazil, Mexico, Russia and others, while having made great strides in the past decade, currently appear to find themselves in this trap, and of course today all eyes are on China’s ability to avoid this conundrum. In a fascinating white paper out of the Federal Reserve Bank of Dallas*, the question of a middle-income trap, and whether China can avoid such a fate, is examined. While a definitive answer to this question is not put forward in this paper, some interesting economic data that sheds light on the issue is offered.

Specifically, there is a powerful tendency for real per-capital GDP growth to slow markedly as countries transition toward middle- and higher-income status (Figure 27), which may also occur in China in the coming decades.

The data the paper presents also strongly hints that (historically, at least) it has been extremely difficult for DM countries, much less their EM peers, to achieve the per-capita living standards of the lead economy (the US in the period since 1950), although the reasons for this remain murky (Figure 28).

In the post–WWII context, it is possible that the US’s privileged position as the globe’s primary industrial power not severely damaged by the war, as well as the monetary and political arrangements instituted after the conflict, allowed the US to maintain a strong sustainable economic advantage over rivals. The Fed paper states: “It may be that policies appropriate for one stage of development are less effective at later stages and that the institutional structure lacks the agility to adjust as circumstances change.” Further, the Fed paper cites interesting work done by: “economists Barry Eichengreen, Donghyun Park and Kwanho Shin [that] examined a large number of growth slowdowns over the past 50 years... [and they] found that the slowdowns tend to occur when per-capita GDP reaches about $17,000 in 2005 purchasing power parity-adjusted dollars and when per-capita GDP reaches about 58 percent of per-capita GDP in the lead country. Maintenance of an undervalued exchange rate also appeared correlated with the slowdowns.”

While it is impossible to know whether these trends will continue to hold—and, clearly, even if this dynamic could be shown to be transhistorical, the lead economy reference point shifts over time—this data does suggest interesting implications for understanding how growth rates might change in the course of development. Of course, as discussed earlier, growth is not necessarily indicative of investment returns, so direct investment implications of insights gleaned from this data may still be far off.

In the end, there are myriad risks to the sustainability of the growth rates we have seen in EM markets in the recent past. In our view, some of them appear less likely (natural resource scarcity and sustained price spikes) and others are more serious (the need for resolution in global imbalances, as discussed in the preceding section, for instance). But ultimately, it is clear to us that EM countries will continue to see growth rates significantly in excess of their DM counterparts for some time to come.

The old saw in economics that generalized price inflation occurs due to “too much money chasing too few goods,” not only underscores the chief importance that capital flows play in the creation of inflationary phenomena, but also serves as a good analogy for the technical asset price inflation seen in the emerging markets arena in recent years. A variety of factors—including greatly improved country and company fundamentals in EM markets, stronger corporate governance and government policy formation, and the relative decline of DM country status—has helped drive capital toward EM countries and companies in recent years. Additionally, many DM institutional investors in have historically been under-invested in the EM space, whether in fixed income or in equities, so some of the capital flows to the emerging world have been a response to correcting that imbalance. In fact, many surveys of institutional investors have indicated that EM markets, across the capital structure, continue to be areas of interest for further allocation.

Another important point to consider regarding capital flows into EM equity and debt markets is the rise of the ETF vehicle, which has both an institutional and retail investor base, making it an interesting indicator of capital flow dynamics. Currently, EM equity ETFs have seen much greater asset flows than have debt-focused ETFs, partly for reasons of market size and accessibility, but the key factor is that there has been a tremendous amount of interest in (and capital flowing toward) emerging markets via the ETF marketplace (Figure 29). Interestingly, assets in ETFs focusing on emerging market equities are double those of ETFs investing in European equities, but that is with total European equity market capitalizations at double the size of emerging markets region capitalizations, illustrating well the tremendous demand from this type of investor.

Given the high levels of demand for EM assets, the supply of tradable assets has often not kept pace, particularly when regional differences in historical corporate capital structures are taken into account (Figure 30). For example, the typical corporation in the Asia-ex Japan region has historically held a capital structure with a considerably greater weight in equity, with less debt than US or European counterparts.
In fact, bank loans have historically been the Asian issuers' primary source of debt financing, representing approximately 10% of the typical corporation's capital structure, versus half that level for the average US company. Overall, total debt (both bonds and loans) represents nearly a quarter of US corporate capital structures, and around a third of developed market capital structures, yet despite trends toward increased issuance, it still only represents about 17% of Asian corporate capital structures. The upshot is that, for yield-hungry DM investors, there is often insufficient supply of debt to meet demand. Issuance has increased somewhat recently, which has helped improve market depth and liquidity in Asia-area fixed income, but a supply/demand disjuncture still exists.

Finally, beyond the well-known capital flow dynamics of reserve recycling that we have discussed previously, “hot capital flows” from DM to EM countries and companies are concerning from both a valuation and a technical perspective, and of course, the global macroeconomic instabilities we’ve seen in recent years are only intensified by this process. The danger, of course, is the herd behavior that is often exhibited by investors of all stripes, and while capital flows into EM markets appear fundamentally sound, the situation remains tenable. But should capital outflows become the norm, and intensify in the context of a market crisis, we could see a repeat of the old story of capital flight from EM, which has hurt investors and EM economies in the past.

Investors would do well to consider technical factors that could support, or place at risk, investment return potential and indeed growth prospects, such as capital flow dynamics, particularly as many EM countries do not have solid domestic investor bases, and are thus dependant on foreign capital to fuel growth and investment. Despite our enumeration of the risks to EM market growth, and our questioning of the importance of that growth to ultimate investment returns, we believe that there are tremendous investment opportunities within EM markets, across the capital structure.
Investment Implications and Conclusions

In light of our discussion of emerging markets, several investment-related themes emerge across different asset classes that we believe merit emphasis.

Equities

- We believe that brand-name companies with strong competitive domestic/regional positions and some significant barrier to entry (this would include DM companies such as Burberry and Daimler) will continue to prosper.
- We suggest that investors seek out potential or actual world-leader companies with a sustainable technological edge.
- We believe that companies with limited competition by virtue of domestic business conditions—particularly certain frontier market companies—will do well.
- We would suggest avoiding financial companies in countries where financial capital flows are material.
- Greater China represents an important growth theme, in our view. Beneficiaries in this theme might include Taiwanese domestic financials and Singapore wealth management (and the Singapore dollar), among other examples.
- Another potential opportunity, in our view, are the winners from improving corporate governance conditions—Russian equities representing a notable example.

Fixed Income

- EM fixed income in general can potentially benefit from massive asset allocation shifts in favor of income and carry (excess return) based global investments, and portfolio re-allocations away from developed world investments.
- EM fixed income also potentially benefits from the favorable demand dynamics given the massive mismatch between potential investable flows and the limited supply of assets.
- We would caution investors to be aware of sovereigns engaged in measures to regulate capital inflows through various forms of capital controls and the implications for expected returns.

Hard Currency

- We would recommend that investors consider sovereigns with strong balance sheets supported by stable political regimes and prudent policy frameworks.
- We would also suggest that top-tier EM corporate credits in strategic industries represent a compelling opportunity—particularly those that are involved in exports, and are consumption based and services driven.

Local Markets

- We believe that it is very important to determine if you are taking interest rate or currency risk when investing in local markets. In general, these are currency plays by virtue of their short duration.

Interest Rates

- We would suggest investing in high-yielding countries with solid fundamentals. In particular, we recommend focusing on countries that offer positive real rates (i.e., return adjusted for inflation)⁹. For example, South Africa offers positive real rates and good fundamentals. In Latin America, real rates are higher, particularly in Mexico and Brazil.
- We believe that short-duration fixed income has the potential to generate high risk-adjusted returns.
- We recommend a focus primarily on the larger markets, depending on an investor’s time horizon and liquidity profile.

Currencies

- We believe that investors should seek out currencies supported by high carry and/or favorable valuation metrics.
- We suggest that investors view currencies as a stand-alone asset class.

The BlackRock Investment Institute plans to explore additional areas of emerging market investments in the coming months. In the meantime, we encourage clients to contact their relationship managers if they wish to engage in a dialogue about the portfolio allocation implications of this paper, or to examine the emerging markets within a broader global investment strategy.

⁹ Real Rate = Nominal Rate – Inflation.