The Third Coming of Emerging Economies

The current emerging market cycle is beginning to look very different from the previous phases. There are no global tailwinds to propel all markets forward

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When there is no wind, row. That Zen saying is likely to be the mantra for emerging markets in the absence of global tailwinds. The current decade is unlikely to see strong external demand and indiscriminate capital flow that propelled all emerging markets forward over the last decade. It is now up to each developing economy to shape its own destiny, making for a very different environment than what we have seen in the previous phases.

The idea of foreigners investing in stocks and bonds of emerging markets first gained traction in the mid-1980s, when Wall Street started to track these nations as a distinct asset class. At the time, they represented less than 1% of the money in global stock markets, but growth would be explosive out of the gates. It was a chaotic period of discovery, in which many nations were opening to foreign investors for the first time: Taiwan opened in 1991, India in 1992 and South Korea the following year, but limited to 10% minority stakes, followed by Russia in 1994.

China, of course, is still only partially open as foreigners have limited access to companies on the Shanghai exchange, and to gain exposure to the mainland largely invest in Hong Kong-listed Chinese companies. Still, the mounting interest unleashed a helter-skelter 600% boom (in dollar terms) between 1987 and 1994. Over this seven-year stretch, the amount of money invested in emerging nations rose from less than 1% to nearly 8% of the global stock market total, but this dawn would prove premature.

The ensuing bust sent foreign investors packing. As a series of crises struck economies, from Mexico to Thailand and Russia between 1994 and 2002, stock markets in the developing world lost almost half their value. What many see as the relentless advance of emerging markets was actually the rise of China alone: between 1987 and 2002, the emerging market share of global GDP fell from 23% to 20%, even as China's share more than doubled to 4.5%. China was carrying the pack on its back, and by the end of this period, the emerging market share of global stock markets had fallen back to less than 4%. Even as recently as 2002, global asset allocators often pondered why they should bother investing any money in such a marginal asset class.

Back in the late 1990s, it was impossible to get investors interested in anything that did not involve technology and the US, and emerging markets had to be marketed as 'e-merging markets', as analysts spent a lot of time searching for the new Silicon Valley, which they dutifully, but often implausibly, discovered hiding in loft offices from Prague to Kuala Lumpur.

It was only after 2002 that the group as a whole really started to take off. Since that year, the emerging market share of global GDP began a dramatic climb from 20% to 34% — due in part to the rising value of emerging market currencies — and its share of global stock markets rose from under 4% to over 10%. This leap covers the period that can be called the second coming — the great synchronised boom from 2003 to 2007.

Stock markets in the developing world then collapsed by 60% during the Great Recession, only to recover most of the losses in the recovery year of 2009. Since then, it has been slow going, with many large emerging markets locked in a trading range. This is really the 'third coming' of the emerging markets, which represents their coming out party as mature markets.

The third coming does not have a bottomless tide of easy money to fuel indiscriminate investment in emerging markets. Since the depth of the 2008 crisis, the emerging markets have rebounded by over 100%, but that is typical after a deep bust, and it is unlikely that these markets will grow that fast going forward.

The maturing of China's growth profile should moderate the average pace of growth in emerging markets from nearly 7% over the last decade to around 5%, with some of the other big emerging markets dependent on Chinese demand slowing meaningfully. The Russian economy could expand at a far less impressive pace of 4% compared to the 7% rate of the past decade, while overhyped Brazil will be stretched to grind along at 4%. Since stock markets largely reflect economic growth, expect emerging stock market gains to slow down from 37% in the period 2003-07 to more like 10% in the coming decade, especially with local stock markets and currencies no longer cheap.

The big story in the developing is that in this slower and more volatile world, the growth rates of countries and companies will start to diverge, so the third coming will be about understanding the emerging markets as individual nations, no longer lumping them into broad categories that don't make sense. This is as true in politics as economics.

For example, the concern in the West over the rise of the major emerging markets as a political bloc, coming together of Brics-type summits, is greatly exaggerated. Look closely at the core of this group — Brazil, Russia, India, China and South Africa — and what you see is nations with competing political interests — for example, as commodity exporters versus importers — and surprisingly limited trade links: the reality is that China has fast-growing trade and financial links with the other four, but the other four don't do much business with each other. All will be hard-pressed to find a common approach for growth in a slowing world economy.

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The economic role models of recent decades are going to give way to new models, or perhaps no models, as growth rates start to splinter off into many different paths. In the 1990s, global growth averaged 2.9%, powered mainly by the US, before spiking to 4.7% from 2003 to 2007, powered mainly by the big emerging markets. Now, global growth is likely to go back to the pace of the 1990s, still powered by the big emerging markets — but in a rough environment where few, if any, nations are going to look like heroes. That drop of nearly two percentage points is going to take the swagger out of many journeymen.

In the past, Asia tended to look to Japan, nations from the Baltics to the Balkans tended to look to the EU, and nearly all nations looked to some extent to the US for lessons on how to get growth right. But the crisis has undermined the credibility of all these role models; it is hard to take the US as a paragon of economic virtue and much the same goes for Europe and Japan. Nations that were once clamouring to get into the eurozone, such as Poland, the Czech Republic and Turkey, now wonder why they want to join a club with so many of its members from Greece to Spain struggling to stay afloat. And with even South Korea finding it more useful to learn from Japan's mistakes of the past two decades rather its successes in the earlier period, it is not clear why anyone would study Japan's economic model more closely than South Korea's emergence as a manufacturing powerhouse.

The break-up of the correlations in GDP growth rates of developing economies is already apparent with trend growth in countries such as Russia and South Africa settling in at a far lesser rate compared to the pre-crisis average whereas Indonesia and Turkey appeared to have regained the mojo of the past decade. The first cracks of a breakdown in the otherwise mind-numbing financial market correlations are starting to show up as well. Since 2010, there has been an increasing flow of money away from state-run companies, away from companies with unstable revenues and to firms that sell consumer staples, show steady growth and get high ratings for solid management.

The cracks in the highly-synchronised movement of economies and stocks are bound to grow, and be a defining feature of the 'third coming': the maturation of the emerging markets into grown-up economies, treated as individuals, not one unruly class by global investors.

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