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## Coming of Age — Graduating From Emerging Status

**W**arren Buffet once wittingly observed that "a pack of lemmings looks like a group of rugged individualists compared with Wall Street when it gets a concept in its teeth." The latest big idea the Street has sunk its teeth into is the notion of economic "decoupling". The theory holds that emerging economies have developed to the point that they no longer depend on industrialized countries for growth, leaving them insulated from the current slowdown.

To date, the outlook for emerging markets is mixed. Stock markets – both in industrialized and developing countries — have declined sharply. But economic figures continue to come in positively. First quarter GDP growth in China was 10.6% — well above economist expectations. Investment performance and flows into exchange-traded funds also provide support to the decoupling camp. Barclays' flagship emerging market fund (NYSE:EEM) — the third largest ETF in the world — is down only 14% on the year versus the S&P 500 decline of 18%. Commodity markets also continue to soar, along with investment inflows. According to ICI data for the year ending February, assets in US commodity ETFs increased 25.7% despite only a 15% increase in the broad CRB commodity index.

**The Shackles of Wall Street Vernacular** The media has framed the decoupling debate in binary terms. Can they sustain their own growth or can they not? But a more useful way to approach the topic is to examine the extent to which different regions are evolving and moving to their own economic rhythm.

The term "emerging markets" itself is ambiguous and increasingly obsolete. The origin of the phrase can be traced back almost three decades to 1981 when a director at the World Bank sought to replace "third world" with something more appealing to investors. More recently, BRIC (*Brazil, Russia, India, China*) has become the latest moniker for marketing departments to run with. State Street, Barclays and Claymore have all launched ETFs based on BRIC indices. Canada's Claymore BRIC ETF (TSX:CBQ) has already accumulated CAD 173 million since inception.

Lumping all developing countries into one category may help investment sales, but it is not particularly helpful for understanding the unique aspects of individual

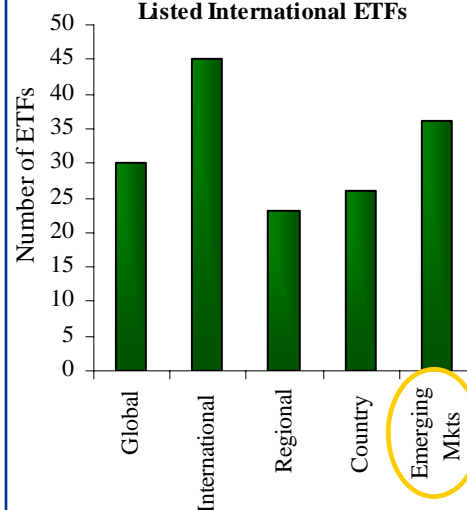
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*"Mention risk to investment advisers in the West, and they will usually cite emerging markets ... if risk today is high GDP growth, double-figure increases in corporate profits, large current account surpluses and strong currencies – with risks like that, who needs opportunities?"*

 David Fuller, Global Strategist,  
 Fullermoney

**Geographical Classification of US  
Listed International ETFs**


Source: Investment Company Institute

### Emerging Markets Better Positioned to Weather Slowdown



Source: Global Insight. Industrial countries as categorized by International Monetary Fund. Emerging market outperformance measured by MSCI Index values.

markets. Underlying economic fundamentals are not homogenous. Market dynamics in India differ greatly from those in Russia. And countries develop in their own unique way. What metric could be applied to determine if a country has “emerged”? South Korea is still often tagged with the label despite having per capita incomes well above the group average and being a member of the OECD. Clearly we are in need of a revised description for this asset class ... or none at all.

**Current Crisis - Made in America?** For many market participants in the Western world, emerging markets have become synonymous with risk. Over the last 25 years, catastrophic financial crises have been witnessed in many of these countries. The Tequila crisis in Mexico, the Russian default, the Asian crisis and the eventual devaluation and default in Argentina in 2001/2002 all had their origins in peripheral markets. But the current crisis is emanating from the core of the industrialized nations – the United States. Where, then, lies the risk today? Our view is that the fundamentals of many emerging nations have improved dramatically over the last decade. Although a slowdown in the developing world is already unfolding and full decoupling cannot be realistically expected, many countries are better positioned to weather this economic contraction.

What has made emerging markets more stable? And what makes them less susceptible to crises in the future? In the recent past, crises were triggered by debt defaults, currency crises, or large fiscal deficits. Risks from the above have been drastically reduced. In fact, fundamentals in emerging countries now often outshine their developed rivals. And many are increasingly becoming driven by their own domestic demand instead of an unhealthy reliance on exports. China is now a larger export destination for the rest of the developing world than the United States. A recent study by CLSA Asia Pacific calculated that over the past ten years consumption spending in China has surged 136 per cent – even after adjusting for inflation.

Corporations in developing nations are also progressively in better competitive positions. In contrast to emerging market firms, OECD companies are handicapped by higher operating costs and growing pension liabilities. Developing nation companies are also expanding their operations, no longer just acquisition targets for Western multinationals. Witness Chinese firms seeking to secure resource companies all over the world. Or Consider India’s Tata Group who bought the telecoms arm of US-based Tyco and recently acquired British brands Jaguar and Land Rover, part of Ford Motors' Premier Automobile Group.

**Positioning Portfolios** History shows that people are slow to adapt to changes. The past often weighs too heavily on future decisions. Money managers are no different. The emerging market crises of the last two decades created frameworks and models for portfolios that are in desperate

need of refurbishment. Popular institutional benchmarks such as Morgan Stanley’s EAFE (*Europe, Australasia and Far East*) or Lehman’s international bond index exclude many important developing markets. Retail investors often use the iShares MSCI EAFE (*NYSE:EFA*) for international exposure despite only covering developed Europe and Asia. The ETF has over USD 45 billion in assets, making it the second largest in terms of asset size worldwide.

Looking at the S&P/Citigroup equity index, emerging Asia still only accounts for 4.8% of world stock market capitalization, while the US accounts for more than 40%. Given comparative economic fundamentals and growth rates, we expect emerging Asia to constitute a much larger portion of this index over the next decade. How then should investors position portfolios? With an expanded set of opportunities, benchmarks should become more global.

Consider Asian fixed income, a regional bond market under-represented in many domestic portfolios. Improving credit quality, significantly undervalued currencies and positive structural economic reforms in the emerging Asian region bode well for future returns. Importantly, regional Asian bonds exhibit negative correlations to many markets including their own stock market and the more developed G7 bond markets.

Trends in the ETF world are more and more facilitating fully global portfolios for the average investor. Barclays recently launched ETFs providing exposure to Turkey, Thailand and Chile. State Street has also expanded their lineup to include a suite of emerging market ETFs splitting up Asia, Latin America, Europe and the Middle East and Africa. ETFs are also proliferating on international exchanges. The Taiwan stock exchange announced plans to list more than a dozen ETFs. And according to Bloomberg, Middle Eastern regulators may authorize the region’s first ETFs. To date, non-resident foreigners can only access Middle Eastern markets through Saudi mutual funds.

**Outlooks and Conclusions** To be sure, emerging market assets are not a one-way bullish bet. Boom and bust cycles have not been repealed. Income inequalities, food price inflation, geopolitical conflicts, managing currency appreciation and environmental degradation ensure a rough ride. Volatility should be expected.

In the current credit crisis, many emerging markets have fallen significantly. But the effects of financial market contagion should not discredit positive forces at play. Economic developments continue to be robust. And reflation efforts by policymakers in the Western world will only reheat growth in these already booming economies. Alternative-type assets and corporate equities, particularly those focused on domestic demand in emerging markets, will provide the best returns in this environment -- position portfolios accordingly.



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