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Emerging Market Economies— A Structural Reduction of Risk

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Emerging market economies have experienced cyclical ups and downs, but many now appear more structurally sound. This improvement, in part, can be attributed to an accumulation of wealth resulting from an increase in foreign currency reserves through commodity exports or labor wage advantage. The longer-term implication of this apparent structural stability is that an allocation to emerging market asset classes has taken on a new dimension of a structural reduction of risk. This dynamic, in turn, can lead to a transformation of emerging market asset classes from "alternative" or peripheral assets to core portfolio assets in many investors' portfolios.

The purpose of this paper is to highlight some of the underlying macroeconomic trends that support emerging market asset classes as they migrate to becoming traditional, core asset classes. The basic factors to be discussed include: critical mass as a portion of global GDP, foreign exchange reserve accumulations, current account trade balances, emerging middle classes and rising disposable incomes, the emergence of robust central banks, reduced inflation rates and low national debt and deficits.

From our perspective, these factors have three implications. First, emerging market sovereign debt issuers have generally migrated to investment grade credits. The impact of this is that emerging market debt as an asset class has seen a reduction in its correlation to non-investment grade corporate debt indices and an increase in its correlation to investment grade indices. Therefore, hard currency (or dollar-denominated) emerging market debt is trading at a much lower risk premium than historically versus high yield.

Second, it is possible that this risk premium compression is secular, not cyclical. In other words, it may be a one-time transformation in the perceived "riskiness" of the emerging market debt asset class. If so, it is possible that emerging market debt is a canary in the coal mine for the emerging market equity risk premium. Emerging market equities could be on the precipice of a similar one-time risk premium change. Such a scenario could provide a unique opportunity to overweight strategic asset allocations toward emerging market equities.

Third, to the extent that emerging market debt has morphed into more of an investment grade sovereign or duration risk-characterized investment, then emerging market currencies may be in for a similar transformation. This would have positive implications for investors using these currencies more as a store of wealth, and it would represent the enhanced appeal of investing in emerging market debt in the form of local currency debt and corporate debt. Currency might in this manner be viewed as the shortest possible duration form of debt.

Subsequent to the publication of the current paper on the macroeconomic evolution of emerging market economies which is supporting their capital markets transformation, we plan to publish a series of additional papers focusing on the various implicated asset classes—emerging markets equity, fixed income and foreign exchange.

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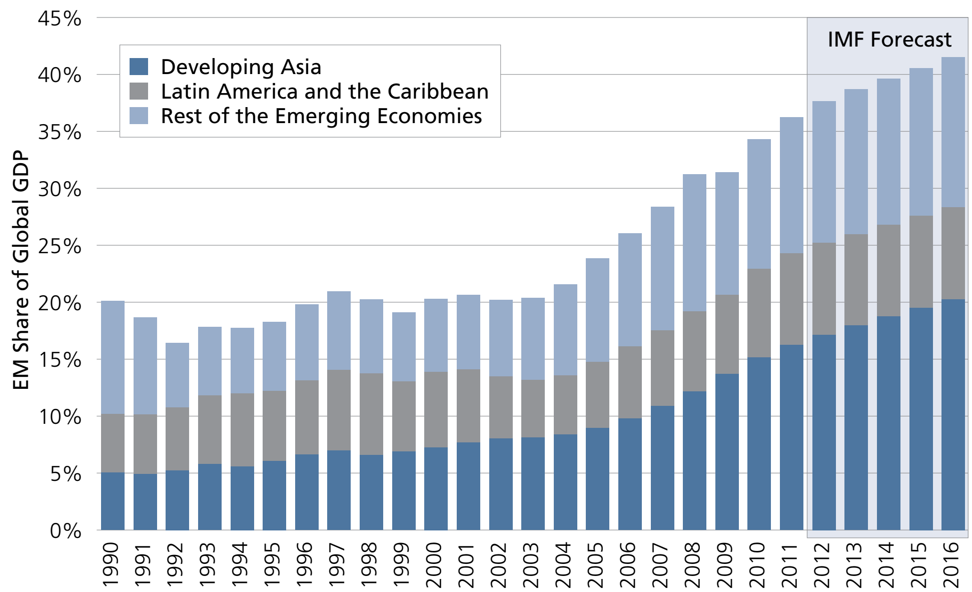
GDP GROWTH

Emerging economies' share of global GDP has grown from 21% to 36% in the last decade. Going forward, this number is expected to continue rising, given the growth differential between emerging and developed markets, and is estimated to reach 40% by 2015 (see Figure 1).

FIGURE 1: EMERGING ECONOMIES' SHARE OF GLOBAL GDP IS EXPECTED TO KEEP GROWING



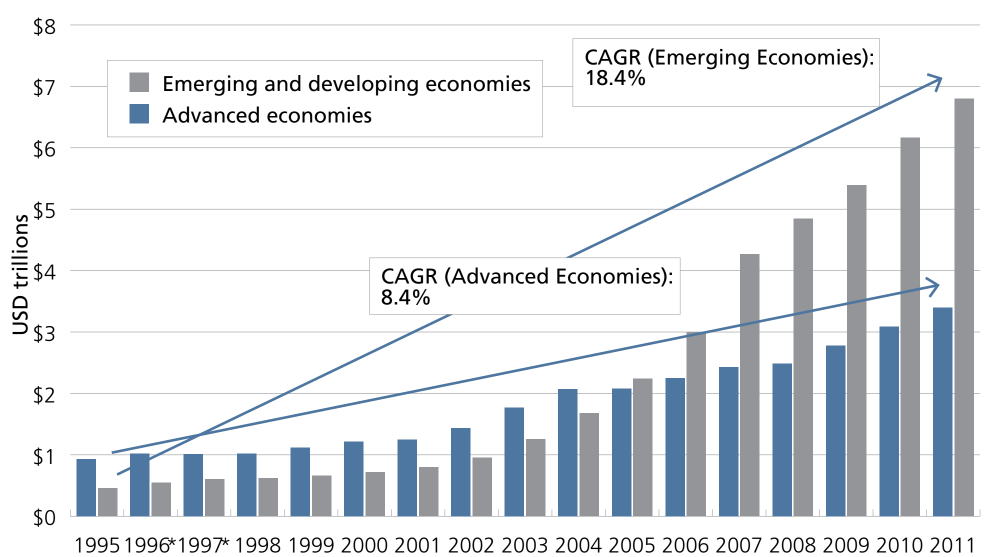
Sources: IMF *World Economic Outlook*, Neuberger Berman.

FOREIGN EXCHANGE RESERVE ACCUMULATION

Export-driven growth has enabled emerging economies to substantially increase their currency reserves. From 2000 through 2010, Asian central banks accumulated \$3.5 trillion of foreign currency reserves (of which China accounted for \$2.3 trillion). Overall, emerging market foreign exchange reserves stood at \$6.8 trillion as of the end of 2011, compared to \$3.4 trillion among developed countries (see Figure 2). Foreign exchange reserve accumulation has been robust across many emerging market countries (see Figure 3), which has given them a greater ability to support their respective domestic currencies in the event of crisis. Such events had been a source of currency dislocation in these countries in the past (the all-too-vivid memories of the Asian financial crisis of 1997–1998 have helped drive strong foreign exchange reserve accumulation throughout Asia, for example). Thus, strong foreign exchange reserve accumulation is a positive development that can help lessen the possibility that crises will harm local emerging market currencies as much as in the past.

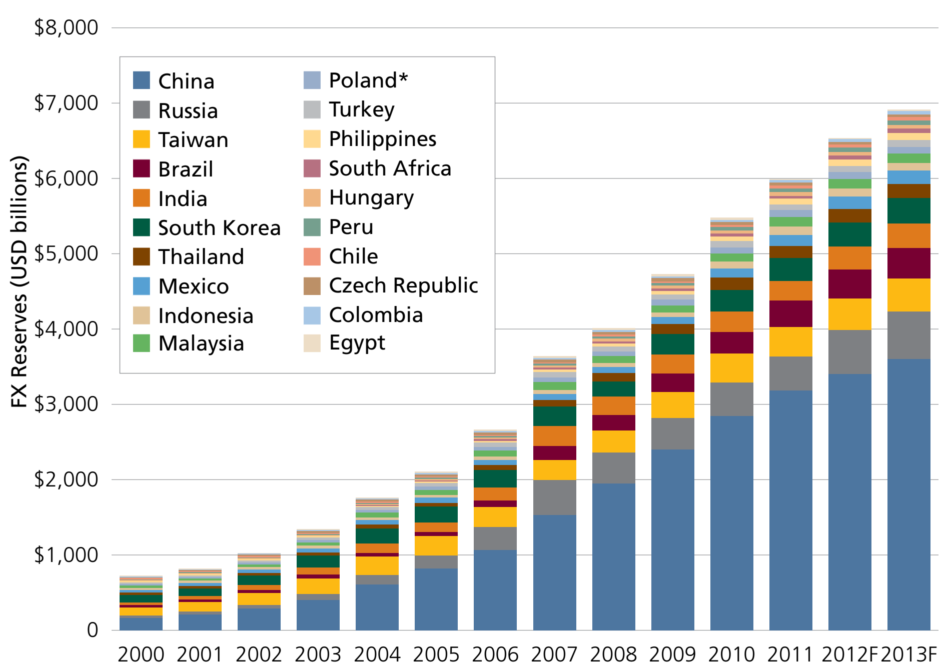
Emerging market foreign exchange reserves stood at $6.8 trillion as of the end of 2011, compared to $3.4 trillion among developed countries.

FIGURE 2: EMERGING ECONOMIES HAVE INCREASED THEIR FOREIGN EXCHANGE RESERVES AT A MUCH FASTER RATE THAN DEVELOPED ECONOMIES



Sources: IMF, International Financial Statistics and WEO. Note: * indicates that during those years, countries with sizable reserves either joined (began reporting) the sample or left (stopped reporting) the sample.

FIGURE 3: EMERGING ECONOMIES' FOREIGN EXCHANGE RESERVE GROWTH HAS BEEN STRONG, WITH CHINA DOMINATING

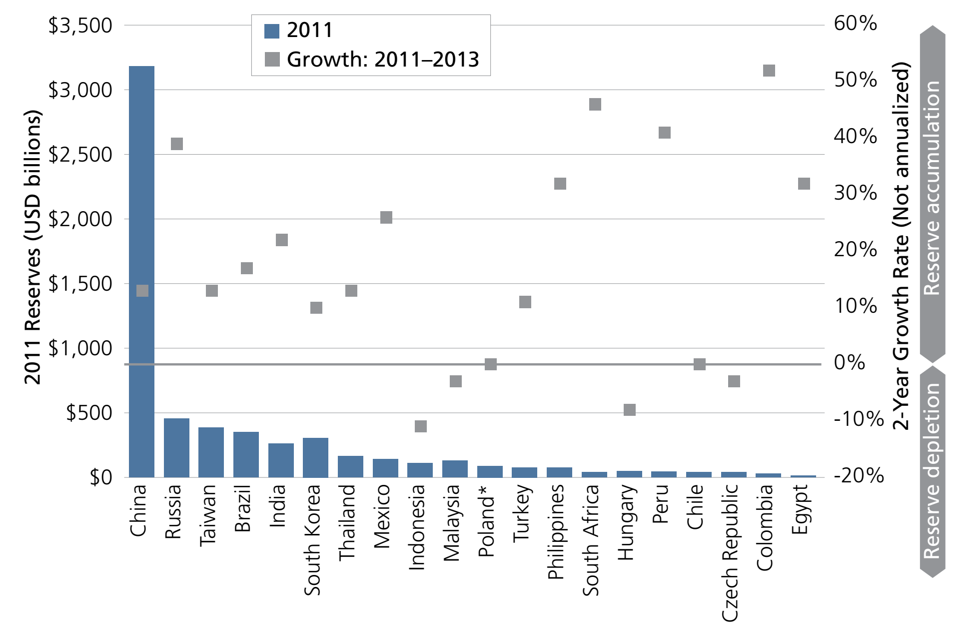


Sources: Neuberger Berman, Bloomberg (actual foreign exchange reserve figures), Deutsche Bank Emerging Markets Monthly Report for June 2012 (forecast figures). Note: * indicates that forecasted foreign exchange reserves for the country are not available, so 2011 foreign exchange reserves for the country are used as a proxy for 2012 and 2013 forecasted reserves. Figure portrays MSCI Emerging Market Equity Index member countries.

Foreign exchange reserve accumulation has been robust across many emerging market countries, which has given them a greater ability to support their respective domestic currencies in the event of crisis.

Furthermore, foreign currency reserves of emerging economies are expected to continue to grow quickly. Figure 4 shows levels of reserves by country at the end of 2011 and the estimated growth rate of reserves for the subsequent two years (through 2013).

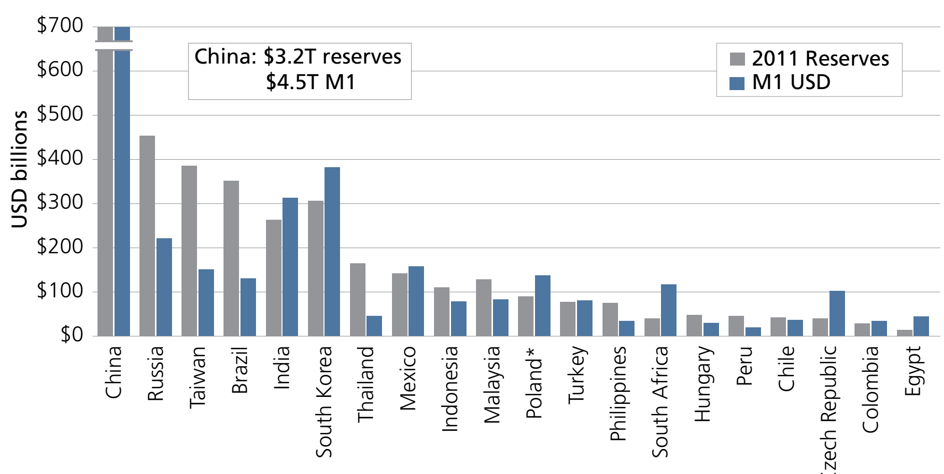
FIGURE 4: EMERGING ECONOMIES' FOREIGN CURRENCY RESERVES ARE EXPECTED TO CONTINUE TO GROW QUICKLY



Sources: Neuberger Berman, Bloomberg (actual foreign exchange reserve figures), Deutsche Bank Emerging Markets Monthly Report for June 2012 (forecast figures). Note: * indicates that forecasted foreign exchange reserves for the country are not available, so 2011 foreign exchange reserves for the country are used as a proxy for 2012 and 2013 forecasted reserves. Figure portrays MSCI Emerging Market Equity Index member countries.

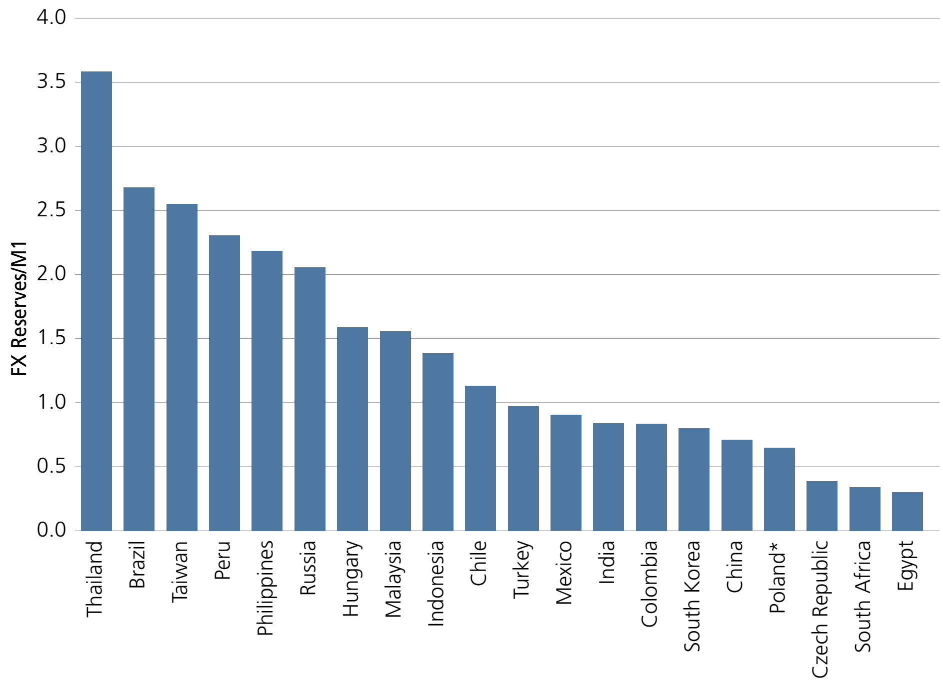
Another consideration of foreign currency reserve accumulation can be viewed relative to a country's own money supply (see Figures 5A and 5B). This juxtaposition compares the magnitude of foreign currency reserves that may be available to defend a local currency.

FIGURE 5A: EMERGING ECONOMY FOREIGN EXCHANGE RESERVES COMPARED TO LOCAL MONEY SUPPLY (M1)



Sources: Neuberger Berman, Bloomberg. M1 as of June 2012; originally stated in local currency terms and translated into U.S. Dollars using June 30, 2012 spot price levels. Note: * indicates that forecasted foreign exchange reserves for the country are not available, so 2011 foreign exchange reserves for the country are used as a proxy for 2012 and 2013 forecasted reserves. Figure portrays MSCI Emerging Market Equity Index member countries.

FIGURE 5B: EMERGING ECONOMY FOREIGN EXCHANGE/LOCAL MONEY SUPPLY (M1) RATIO



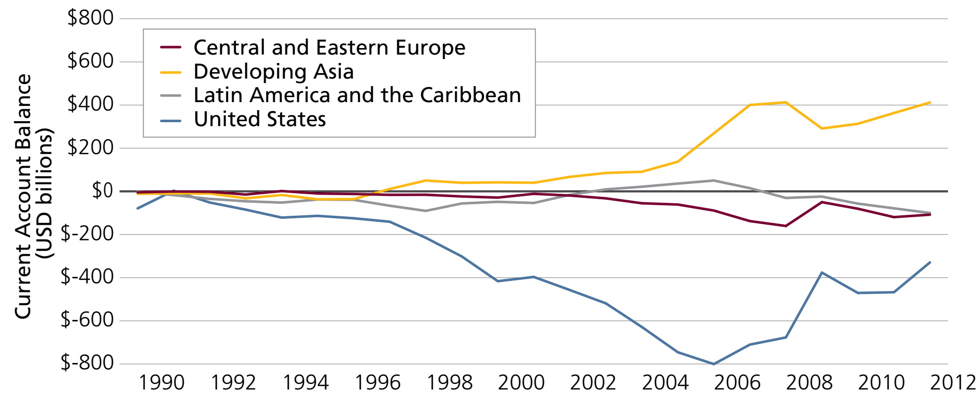
Sources: Neuberger Berman, Bloomberg. M1 as of June 2012; originally stated in local currency terms and translated into U.S. Dollars using June 30, 2012 spot price levels. Note: * indicates that forecasted foreign exchange reserves for the country are not available, so 2011 foreign exchange reserves for the country are used as a proxy for 2012 and 2013 forecasted reserves. Figure portrays MSCI Emerging Market Equity Index member countries.

CURRENT ACCOUNT SURPLUS

Current account surpluses, provided by raw material exports or competitive labor rates and manufacturing positions, often are the root cause of the aforementioned foreign currency reserve growth and accumulation. The current account surplus (i.e., trade surplus) in Developing Asia has grown quickly since the turn of the century, buoyed by strong export growth. In other emerging economies (Central and Eastern Europe and Latin America), however, current account balances have declined marginally (see Figure 6A). Some of this, especially in Latin America, relates to increasing domestic consumption, which is being fueled by emerging middle classes. Notably, the current account balances in emerging economies are significantly above that of the United States.

Current account surpluses often are the root cause of foreign currency reserve growth and accumulation.

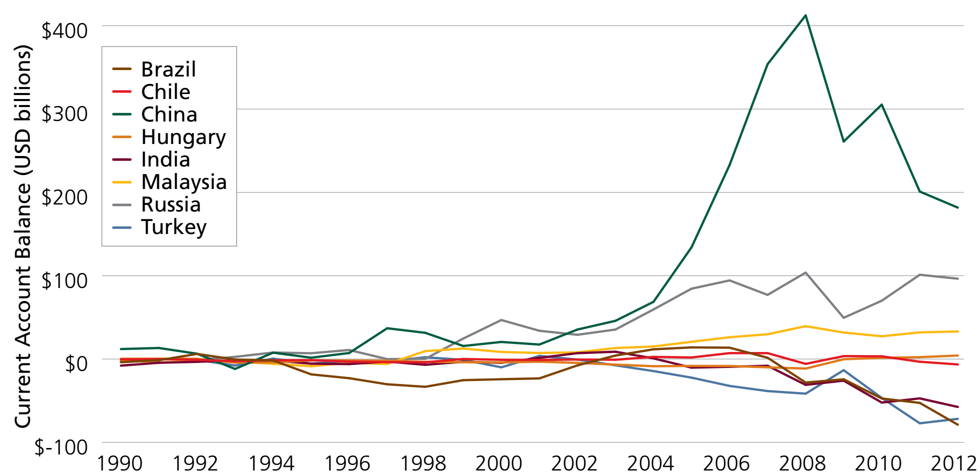
FIGURE 6A: CURRENT ACCOUNT BALANCES HAVE GROWN RAPIDLY IN DEVELOPING ASIA COMPARED TO THE REST OF THE WORLD



Source: IMF.

The current account balance varies significantly by country within the emerging economy universe (see Figure 6B). While China and Russia, for example, have seen significant improvement in their current account position (China in large part due to export demand from the developed world; Russia from oil exports), India, Brazil and Turkey have seen growing current account deficits. In the case of India and Turkey, current account balances are impacted by the fact that the countries are net importers of oil—a structural imbalance that is not expected to change in the near to medium term. India is also a net importer of other energy supplies (coal and gas), as well as gold—a dynamic that is expected to continue as well.

FIGURE 6B: CURRENT ACCOUNT BALANCES OF SELECT EMERGING ECONOMIES



Source: IMF.

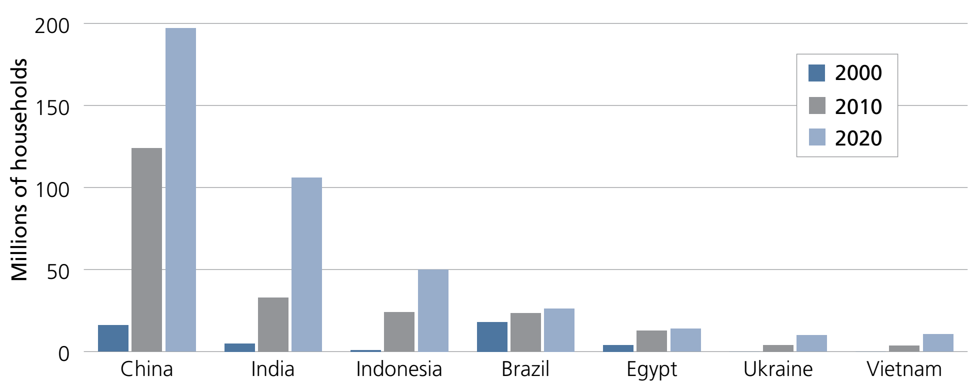
Global economic slowdown impacts emerging economies' current account balances and foreign exchange reserve accumulations—particularly for export-driven economies. As the U.S. and Europe have recently experienced economic slowdowns, this has reduced demand for exports from emerging countries, leading to slower foreign exchange reserve accumulation and weakened current account balances.

EMERGING MIDDLE CLASS

While foreign currency reserve accumulation through trade surpluses may have provided for prospective local currency and asset class stability, future growth in emerging economies may increasingly come from domestic consumption. Domestic consumption is being driven by growing middle classes that have higher disposable incomes. As Figure 7 shows, in some emerging countries the number of households with annual disposable income of $5,000-$15,000 has been growing rapidly, particularly in China, India and Indonesia. Historically, $5,000 in household income has been a point of critical mass, where domestic consumption starts growing robustly.[1]

As middle classes gain the purchasing power necessary to increase consumption and improve standards of living, emerging economies tend to transition from being dependent primarily on exports to developed countries to having more balanced growth, driven increasingly by domestic consumption and investment in local infrastructure. Domestic consumption generates growth for many consumer staples, consumer discretionary and health care companies. Infrastructure investment produces growth for industrial and materials companies. Such investment is critical in these countries, as it helps to improve efficiency, increase capacity and potentially mitigate inflationary pressures.

FIGURE 7: GROWTH IN THE NUMBER OF HOUSEHOLDS WITH ANNUAL DISPOSABLE INCOME OF US$5,000–$15,000



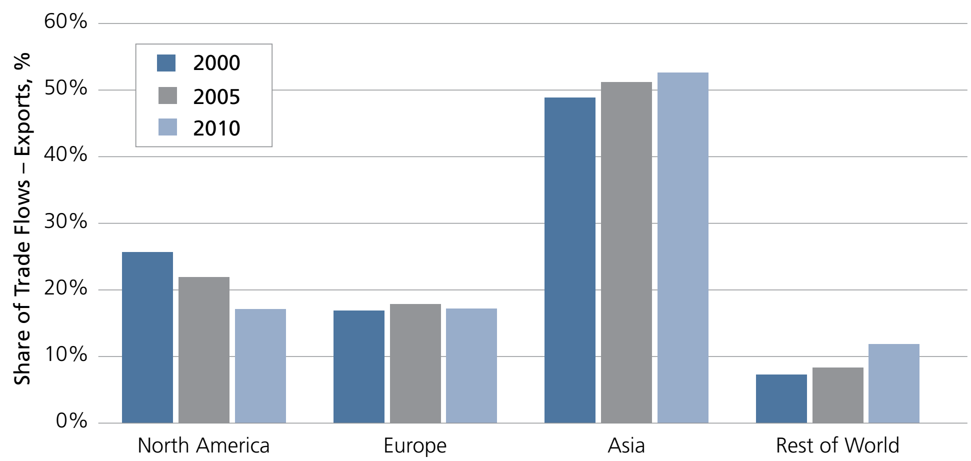
Source: Euromonitor International. Data for 2010 and 2020 are forecasts.

The composition of export demand from emerging economies also has been changing, with more trade occurring intra-region and among developing countries and less trade taking place with the U.S. and Europe (see Figures 8A and 8B). This has made emerging economy exports more diversified, and has reduced the magnitude of contagion from the malaise in the Western world. Figures for Asia are impacted by China's increasing reliance on Latin America for commodities imports.

[1] As countries have moved through the GDP per capita curve, amounts below $5,000 in household income have been used primarily for sustenance and savings, and amounts beyond that are for broader consumption.

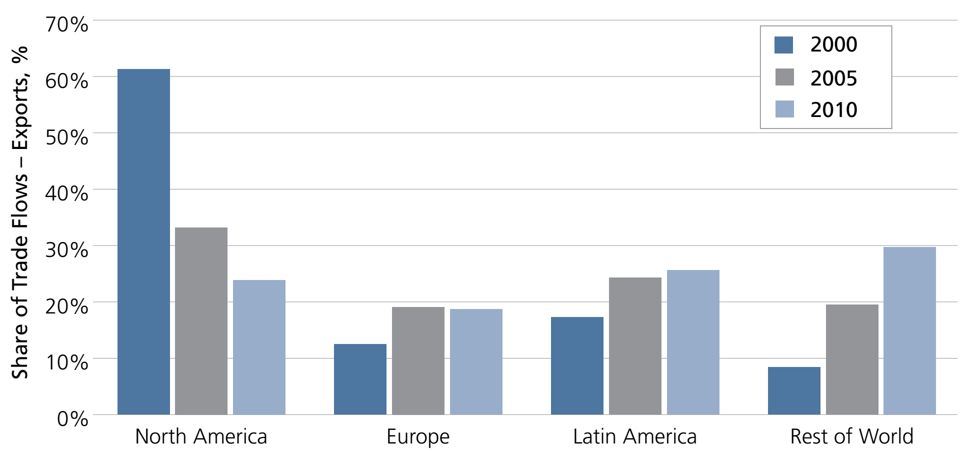
The composition of export demand from emerging economies is becoming more diversified, with more trade occurring intra-region and among developing countries and less trade taking place with the U.S. and Europe.

FIGURE 8A: REDUCED RELIANCE ON DEVELOPED ECONOMIES AS TRADE PARTNERS—ASIA (INCLUDING JAPAN)



Source: World Trade Organization.

FIGURE 8B: REDUCED RELIANCE ON DEVELOPED ECONOMIES AS TRADE PARTNERS—LATIN AMERICA

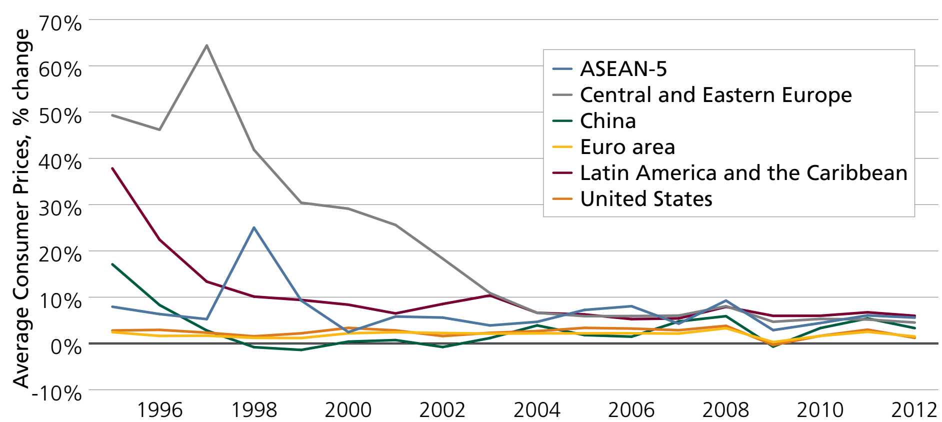


Source: World Trade Organization.

ROBUST FISCAL AND MONETARY POLICIES

Since the 1990s, many emerging market countries have restructured their sovereign debt and instituted fiscal reforms that have set them on a more stable path than was the case in prior decades. Inflation has declined dramatically (see Figure 9) as many central banks raised interest rates in the late 1990s to help tame inflation. Today, inflation in emerging economies is not much higher than in developed economies. Inflation targeting and inflation control are a major focus of monetary policy in many emerging economies. Indeed, reduced inflation has been an important source of economic and financial strength for emerging economies.

FIGURE 9: EMERGING ECONOMY INFLATION HAS DECLINED AND IS NOT TOO MUCH HIGHER THAN IN THE U.S. AND EURO AREA



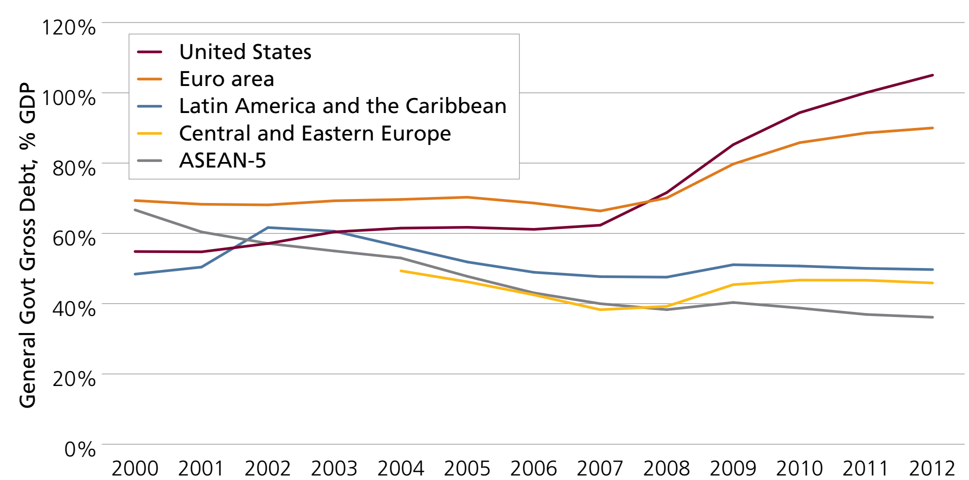
Source: IMF. ASEAN-5 countries include Indonesia, Malaysia, Philippines, Thailand and Vietnam.

To be sure, there is still structural inflation in emerging economies, with wages increasing at a brisk pace. This, in turn, is helping to increase domestic demand for food and energy. Addressing these issues will require additional investments in efficient manufacturing and commodity production capacity, which would help increase productivity and offset some inflationary pressures.

Another favorable trend relates to general government gross debt, which has remained steady or decreased as a percentage of GDP in many emerging economies, while it has risen dramatically in the developed world (see Figure 10).

Emerging economies have experienced significantly improved fiscal health, which has set them on a more stable path than was the case in prior decades.

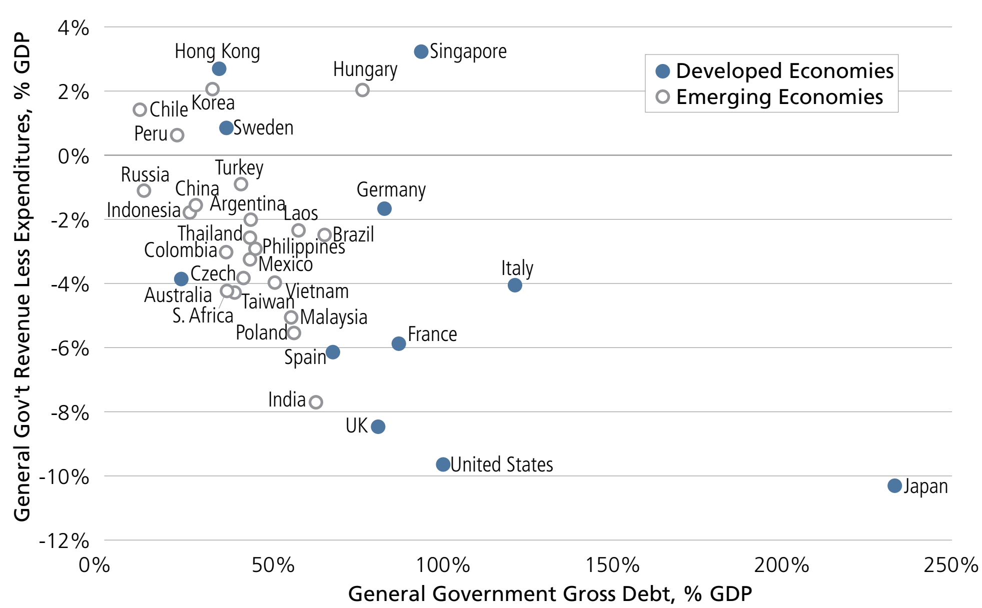
FIGURE 10: GENERAL GOVERNMENT GROSS DEBT HAS GROWN IN THE DEVELOPED ECONOMIES, AND DECREASED OR REMAINED STEADY IN EMERGING ECONOMIES



Source: IMF.

Overall, the fiscal health of emerging economies has improved relative to that of developed economies, with generally less government debt as a percentage of GDP and better fiscal balances (government revenues less expenditures, see Figure 11).

FIGURE 11: EMERGING ECONOMIES ARE ENJOYING BETTER FISCAL POSITIONS THAN DEVELOPED ECONOMIES



Source: IMF. 2011 annual data used.

LOCAL INSTITUTIONS

Fiscal positions in many emerging market countries have also been strengthened through robust local institutions. Sovereign Wealth Funds have accumulated large sums, received in part from the commodity boom, and are investing much of it locally. Private and public pension funds (such as the mandatory savings systems in several Latin American countries, including Chile and Colombia) also invest heavily in their home regions. A significant amount of investment has been directed towards infrastructure projects. Also noteworthy are investments in local companies. These institutions have helped form a stable long-term local investor base, thus contributing to a potential reduction in capital market volatility in these countries.

EMERGING OPPORTUNITY

This ongoing transformation is not new. Perhaps it is muddled by the past turmoil in emerging economies (e.g., the Asian crisis of 1997–1998, the periodic devaluation and debt defaults that occurred in Latin America and Eastern Europe in the last century and the revelations of fraudulent incidents even today). However, the basic strength of many of these countries has rarely been so secularly robust (cyclical weakness notwithstanding), particularly in comparison to the debt-laden status of many developed countries. Perhaps the last hurdle is to develop more consistent governance and reduce fraud and corruption in some emerging market countries. We believe this would fully accomplish the potential for fiscal maturity of their economies and ultimately attract the permanent support of investors. Nevertheless, investors remain significantly underweight emerging market asset classes relative to developed market asset classes. The intricacies and complications of the past for both emerging and developed market economies that brought us to today continue to leave investors with a bias toward historical perceptions of safety. Perhaps we are a short time away from a change in the common set of beliefs that could reveal a new “world order” of how emerging versus development market public assets are valued. Until this new world order emerges, investors may be facing a unique opportunity to increase their allocations to emerging market asset classes at potentially compelling valuations. Or as Winston Churchill noted, “Out of intense complexities intense simplicities emerge.”

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