



## **The Global Credit Crisis and Emerging Markets**

Robert Huebscher

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The credit crisis, an impending recession, and fears of escalating inflation are crippling growth prospects in developed economies. Rather than settling for meager returns in these markets, investors should be aware that over the next several years emerging market equities will likely outperform their developed market counterparts, says Mark Madden, lead portfolio manager of Ninth Wave Capital, a Boston-based global emerging markets fund with \$75 million under management. Following an extreme sell-off in emerging markets, which have declined more severely than developed markets over the past year, emerging market equity valuations are now more attractive and offer higher growth prospects than those in developed markets. They present a compelling opportunity for long term investors.

We spoke with Madden, who has nearly a quarter century of experience in emerging markets, having previously managed a \$2 billion fund for Pioneer Investments and a \$14 billion fund for OppenheimerFunds before starting Ninth Wave in 2007.

Madden explained that emerging market equities have been driven by different emphases over the years, with some periods dominated by a focus on industry cycles and bottom-up stock selection and others more influenced by country or macro factors. For example, during the bull market that ended about a year ago, a sector-based bottom-up approach worked well for his fund. Now, however, the current credit crisis has made macro-economic and liquidity considerations more important. He believes that, over the next several years, sector and stock selection will re-emerge as key drivers of equity performance and the current dominance of macro factors will diminish in importance. "With the global maelstrom, macro issues have become terribly important in 2008," says Madden.

Like many other managers, he explains, Ninth Wave was long commodity companies and short consumer-oriented businesses over the past year. By March of this year, his fund reduced its commodities exposure and began to take more long positions in severely beaten up telecom, industrial and selected financial stocks. (He admits that Ninth Wave was early in its move to reduce its commodity exposure as oil and other commodities prices finally peaked some months later in early July.) With commodity prices falling, and probably set to overshoot to the downside, the risks of higher structural inflation globally are diminishing, allowing central banks around the world to reduce interest rates.



That's good news for many Asian emerging market economies, but it's negative for commodity-producing countries. Global growth will slowly recover over the next several years as lower commodity prices and lower inflation allow for further interest rate cuts. Emerging markets' growth of 4-8% per year should strongly outpace the 1-2% that will likely prevail in the developed world.

To understand how these themes play out in within the emerging markets, we asked Madden to walk us through each of the BRIC economies.

## **Brazil**

After decades of hyperinflation that ended with the Real Plan in 1995, Brazil saw a period of strong growth in the late '90s. The 1997 Asian crisis ended with Brazil devaluing its currency early 1999 and was followed by a period of slow growth that was further exacerbated by high political risk and electricity shortages in 2002. Since then, Brazil has enjoyed strong economic growth driven by rising exports of coal, iron ore and agricultural commodities and by domestic consumption. The ongoing correction in commodity prices and the global credit crisis will no doubt slow Brazil's economic growth in the near-term, but growth should rebound in late 2009 and the equity markets will begin to discount that sometime in the first half of this year.

Madden says the Brazilian central bank has been very prudent in their management of interest rates. The benchmark Selic rate is now 13.75%, roughly 6-7% above the prevailing inflation rate, and he believes inflation in Brazil is peaking. One problem is a big current account deficit, due largely to the consumption boom. But with interest rates at 6-7% (perhaps the highest globally) that deficit should begin to improve. The past weeks of global credit market turbulence have weakened Brazilian currency, but Madden expects it to rebound against the dollar as investors around the world unwind their "flight to safety" purchases of short-term US Treasury bonds.

Brazil raised interest rates even as the Fed cut rates from 5% to the current 2% over the past year, while other countries were slower to raise rates in recent years and so are not in the enviable position to cut rates as dramatically in the coming year or so.

## **Russia**

The Russian economy and government revenues are closely tied to commodity prices, Madden says. He attributes the fall of the Soviet Union to commodity price weakness, and the rise of Russia as a geopolitical force over the last ten years to the recovery in global commodity prices. Putin's attempts to diversify the Russian economy have been unsuccessful, as he has not implemented any



strong policies in this regard. With an overvalued currency and persistently high domestic manufacturing costs, Russia experienced a multi-year consumption boom of largely imported goods supported by exports of oil, gas and a variety of industrial metals.

Inflation has been running at 15-18% (depending on the city or region) and is a major problem for the government in managing the economy. Declining commodity prices over the last three months will dampen inflation, but they will also lower government revenues. The Russian government has benefited in recent years from an oil revenue windfall — its tax take is effectively 90% of the revenue above \$35 per barrel.

The Russian bull market began to unravel in June when the government took action to halt rising materials prices, threatening tax evasion investigations of coal and iron ore companies. Along with the conflict in Georgia, Russia felt the impact of the global credit crisis, which reversed the flow of foreign capital into the country. As credit has tightened, Russian banks have found it more difficult to access wholesale funding, and companies have found it more difficult to tap global capital markets to finance major projects. When the turbulence hit, Russian oligarchs were some of the first to move money offshore. This sell-off has been exacerbated by the forced sale of securities that had been pledged by company insiders to collateralize loans. As a result, Russia has been one of the worst performing markets in the world during the third quarter.

Madden says Russian stocks are cheap right now, but any decision to invest there should hinge on the forecast direction of commodity prices. Madden is not optimistic, and sees further declines in the price of oil from \$90/barrel to \$60-70/barrel for Brent due to the slowing global demand, destocking and unwinding of speculative positions. In the long term, Russian markets look attractive, he says, but he expects more downside in the months to come.

## **India**

“India’s economy is driven by domestic consumption,” says Madden, “and the recent rise in commodity prices ended the consumption boom of recent years.” He believes India is still in a down cycle. India is a net importer of oil, and the Indian government subsidizes the price of oil, fertilizer, and, in some states, electricity. These subsidies increase the government’s budget deficit, although that deficit has come down somewhat recently.

Overall, Madden believes India is going through a period of decelerating domestic consumption that should bottom out sometime in 2009. Indian stocks have seen a huge correction already, but more is yet to come. He also expects strong returns on capital will translate to above-average equity returns.



## **China**

“At this point in the global cycle, China is the most important economy for world growth,” says Madden, “and China’s exports are slowing as the rest of the world slows down.” Nonetheless, China’s real GDP grew by only 9.7% in the past quarter, and Madden thinks this could soon decline to 8% or 9%, all fairly modest in comparison to the 10-11% growth China has experienced over the last few years. In contrast to the growth rate of 1% to 1.5% Madden expects from the US, European, and Japanese economies, even modest growth of 8% in China will create opportunities.

To offset the global slowdown, China’s government must stimulate domestic consumption in its economy, but various government constituencies with a role to play in that process sometimes have competing agendas. President Hu Jintao is most concerned with social harmony and promoting full employment; he pushes for higher growth and supports lower interest rates. The central bank is more focused on managing inflation and stabilizing the currency and the banking system, so he has favored tighter monetary policy. “There is currently no consensus toward radically stimulating growth,” says Madden. The Chinese central bank has lowered reserve requirements, but “China is like a super tanker, and it takes some time for the ship to turn following an adjustment at the helm,” says Madden.

China has a \$1.3 trillion economy, and 45% of total GDP comes from fixed asset formation in manufacturing, property development, and infrastructure. Madden says the downside risk in China is that consumer demand will not allow capital expenditures to continue as they have in recent years. China plans to substantially increase infrastructure investments, but because they represent only 8% of total fixed asset formation (or 4% of GDP), Madden says the economy still needs strong property development and manufacturing capital expenditures to sustain strong GDP growth.

In China, the possibility of growth slowing to around 6% worries Madden. A slowdown of that magnitude, he says, would be a “severe calamity” for China and the rest of the world. But, overall, he believes China will continue to offer many attractive investment opportunities, as it continues to have one of the best long-term growth prospects in the global economy.

### **Is Now the Time to Increase Emerging Asset Allocations?**

Madden says risk premia and spreads in the fixed income markets may well be peaking and, as rates and risk premia recede, he expects capital to flow back into the equity markets. Slow global growth will keep commodity prices in check,



and capital now invested in commodities and cash that was moved to the sidelines will find its way to the equity markets.

“As credit eases, investors will see that emerging markets are healthier in terms of real domestic demand than their developed counterparts,” says Madden. He believes that demand can be tapped, and markets have already overcorrected on the downside.

Madden explained that, in the bull market of 1994, institutions’ thirst for investment in emerging markets was unquenched to the point where they “could not get enough of them.” By September of 1998, emerging markets were down 80% and looked really cheap, but institutional and retail would not go anywhere near them. A year ago, Madden says the environment was like 1994 where investors could not get enough exposure to emerging markets, but now we are approaching negative sentiment like we saw in 1998. “Emerging markets are increasingly attractive on a relative value basis,” says Madden, “but investor appetite for global equities is trending toward a low point.”

Madden forecasts fairly benign growth for the US economy in the next several years, and he has even more modest projections for the mature European economies. While investors can get some exposure to emerging markets through large multinational US-based corporations, he admits, investors get more exposure to the higher growth in emerging market economies and the liquidity therein by investing directly in emerging markets.

Madden points to a lot of institutional assets now sitting in cash, and he believes hedge funds are heavily short on cash as well. As markets begin to recover, these shorts will be covered and the cash deployed, with much of it finding its way into emerging markets. His own fund is now net 30% long in emerging markets, after having been short or neutral for most of the summer. “Emerging markets clearly represent the best growth opportunities on a global basis,” he said. “With valuations at historically low levels, this may not be the exact time to increase allocations to emerging markets, but over the years to come growth in emerging markets will translate to attractive equity returns.”

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