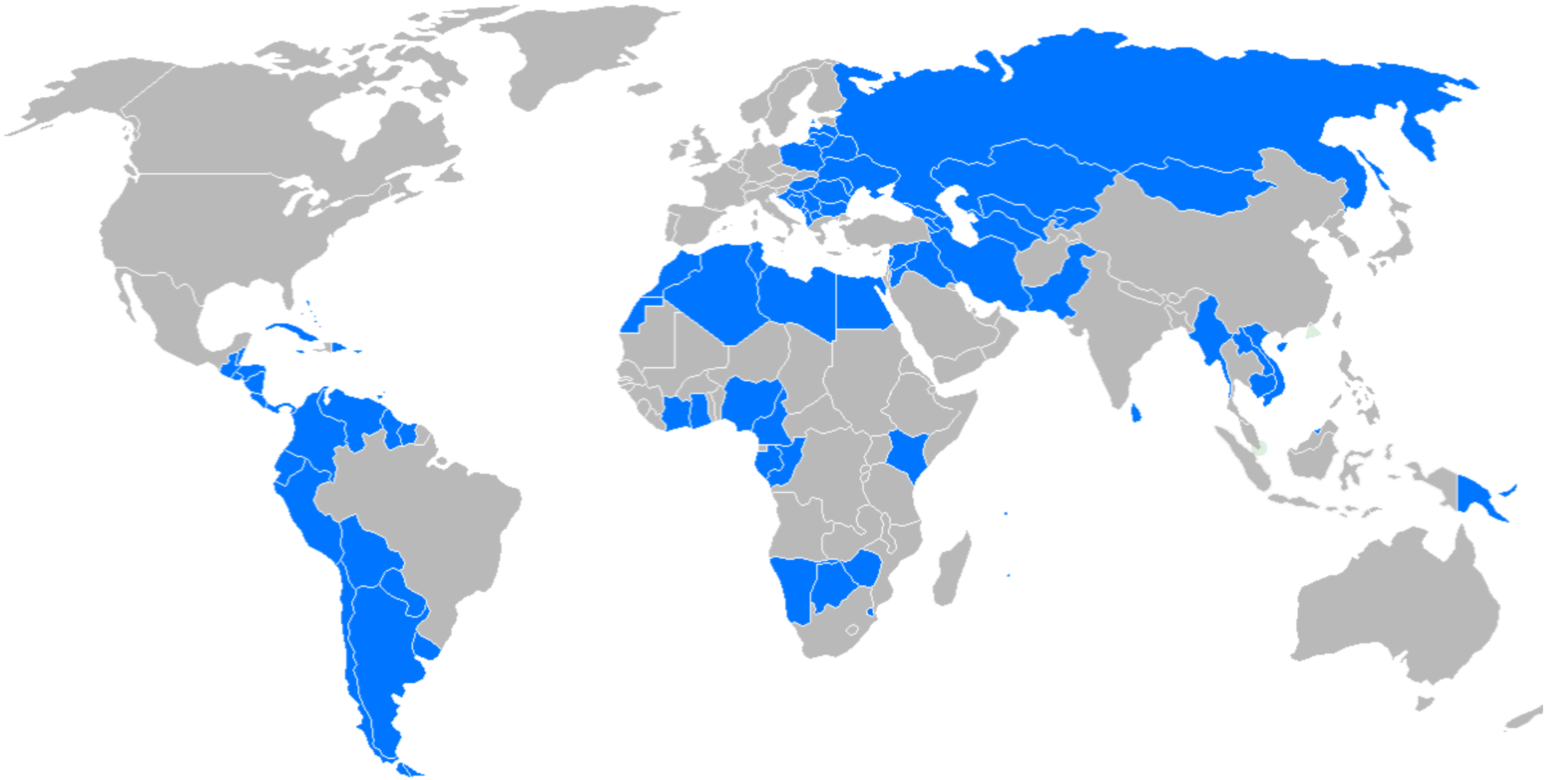
Hour 1

Emerging Markets – Strengths and Challenges



An emerging market is a country that has some characteristics of a developed market, but does not meet standards to be a developed market. This includes countries that may become developed markets in the future or were in the past. The economies of China and India are considered to be the largest emerging markets. According to The Economist, many people find the term outdated, but no new term has gained traction. Emerging market hedge fund capital reached a record new level in the first quarter of 2011 of $121 billion**. The four largest emerging and developing economies by either nominal or PPP-adjusted GDP are the BRIC countries (Brazil, Russia, India and China).**

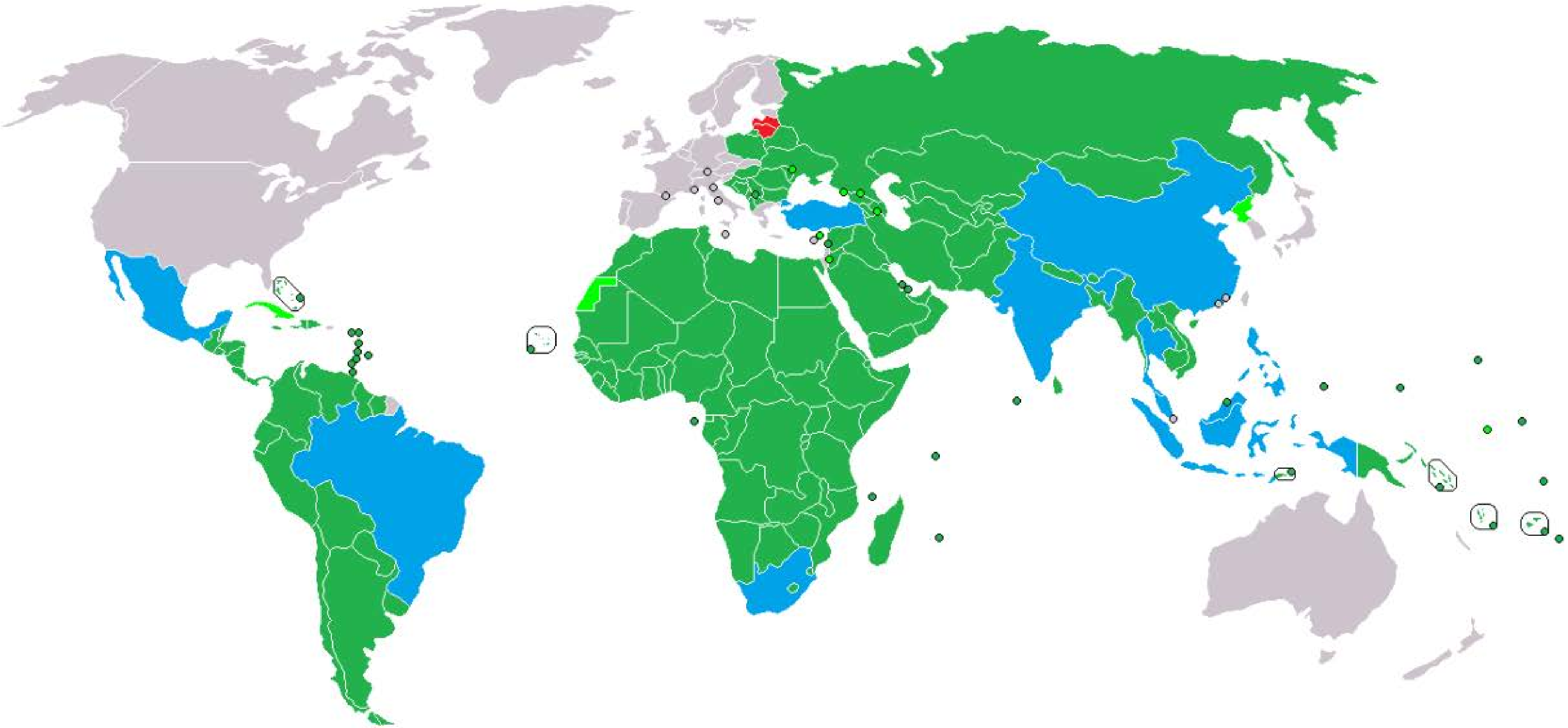
A List of Emerging Markets

- Brazil
- China
- India
- Indonesia
- Mexico
- Russia
- Turkey

- Argentina
- Bangladesh
- Chile
- Colombia
- Egypt
- Iran
- Iraq
- Kazakhstan
- Malaysia
- Nigeria
- Pakistan
- Peru
- Philippines
- Poland
- Qatar
- Saudi Arabia
- South Africa
- Thailand
- Vietnam

- Bahrain
- Bulgaria
- Czech Republic
- Estonia
- Hungary
- Jordan
- Kuwait
- Latvia
- Lithuania
- Mauritius
- Oman
- Romania
- Slovakia
- Sri Lanka
- Sudan
- Tunisia
- United Arab Emirates
- Ukraine
- Venezuela

Newly Industrialized Economies – in Blue



Major Economic Challenges to Emerging Markets

1. Volatile Commodity Markets and EMs

2. Volatile Currency Markets and EMs

3. Inclusive vs. Exclusive Political Institutions

4. Risks for Emerging Markets – geopolitical, social, informational, liquidity risks

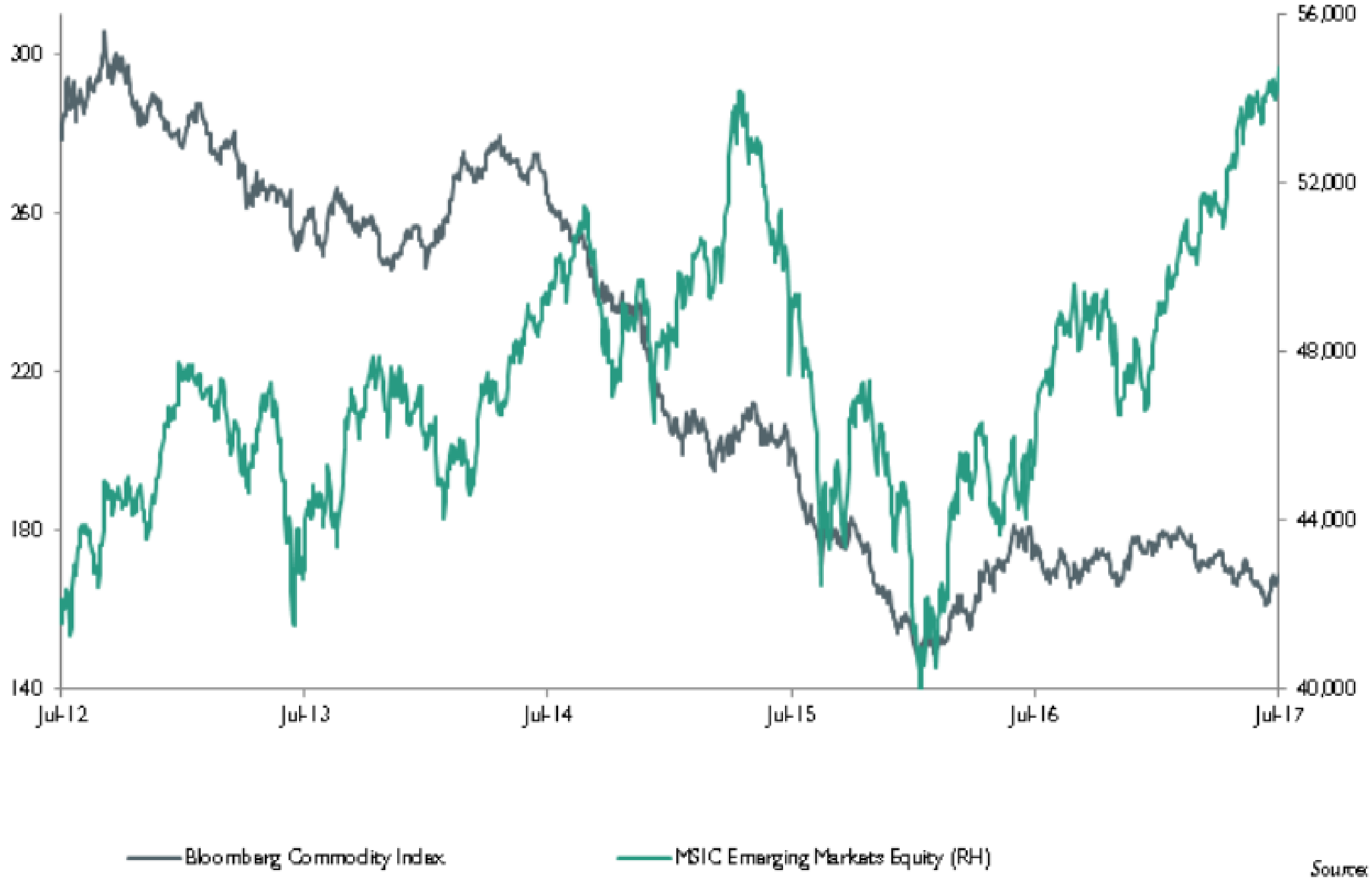
1. Volatile Commodity Markets and EMs

Many of the world's largest emerging markets (EMs) are leading producers and consumers of raw materials. As a result, their business cycles tend to be highly dependent on fluctuations in the global prices of commodities.
For example, Brazil has an abundance of natural resources. It is one of the top producers of agricultural products, has large reserves of crude oil in offshore basins off the Atlantic Ocean and substantial iron ore resources.

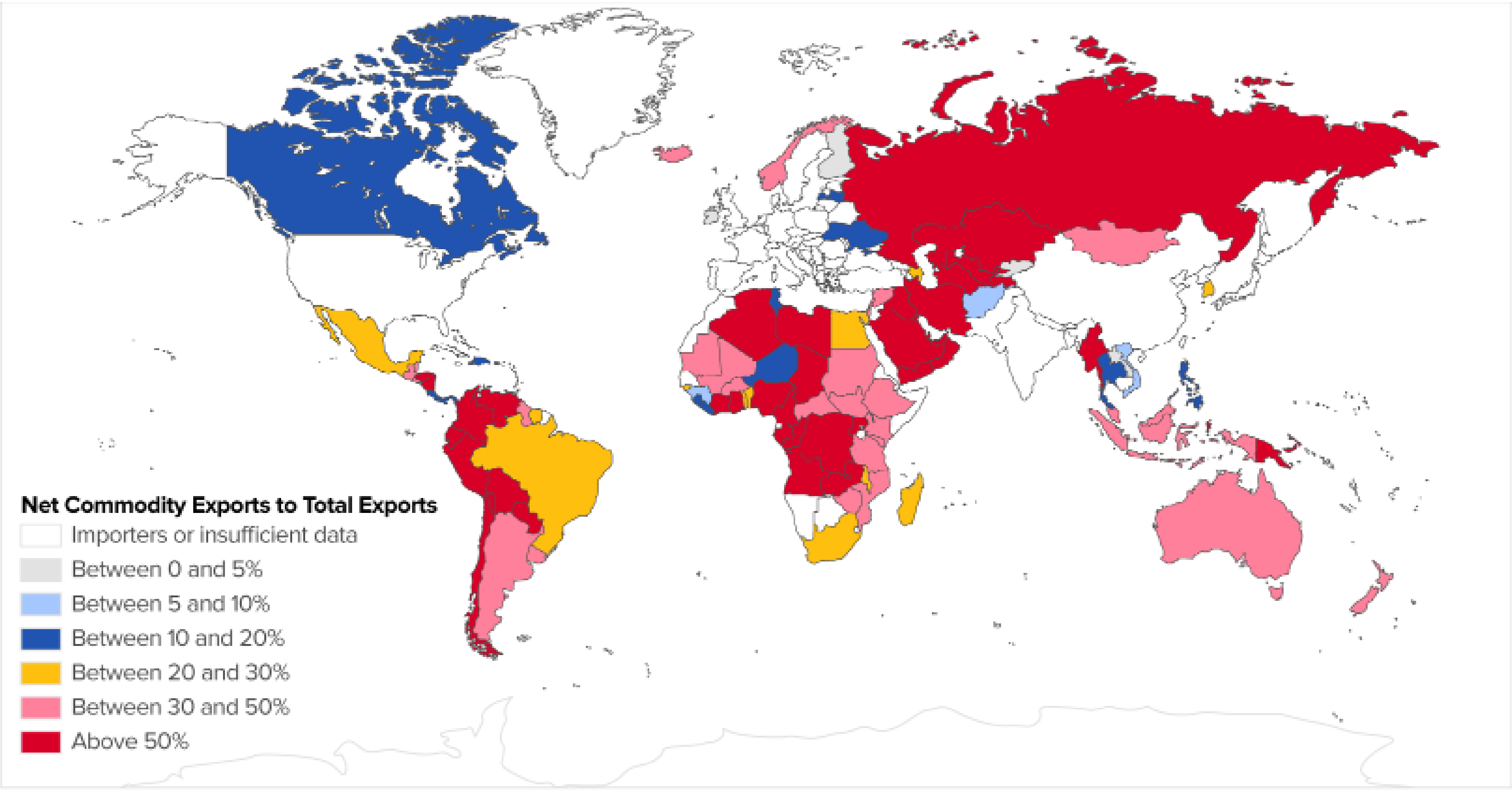
Meanwhile, China – and to a lesser extent India – has surged as an importer of commodities over the past two decades to fuel economic growth. In 1990 China accounted for only 2% of all commodities traded, while the US and Japan accounted for about 15% each. By 2013, China was the leading commodity importer with 15% of global trade, while the US and Japan had fallen to 10% each.

China's stellar growth in recent years was shared by many emerging economies as they provided the exports to sustain its surge. Yet these same economies have also been affected by China's periods of slower growth. Indeed, the decline in commodity prices over the past few years and the slowdown of growth in China go a long way to explaining the recent recessions in Brazil.

EM equities rebounding as commodities stabilise



Source: Datastream


Net Commodity Exports to Total Exports
Importers or insufficient data
Between 0 and 5%
Between 5 and 10%
Between 10 and 20%
Between 20 and 30%
Between 30 and 50%
Above 50%

Prospects for emerging markets remain sound despite the recent increase in volatility. Emerging markets have historically bounced back from external shocks, and they displayed a healthy resilience amid choppy trading in early 2018. There are strong tailwinds underpinning emerging-market equities even as we are mindful of the challenges that may arise.

Importantly, emerging-market economies look poised for further growth. The International Monetary Fund estimates 4.9% GDP growth for emerging markets in 2018, up from 4.7% in 2017.[1] While protectionist trade actions taken by the United States have cast a shadow over the synchronized global growth that has lifted stock markets, the long-term outcome remains to be seen. The scope and strength of international trade flows should not be underestimated, as evident by the historical growth in intra-Asia trade.

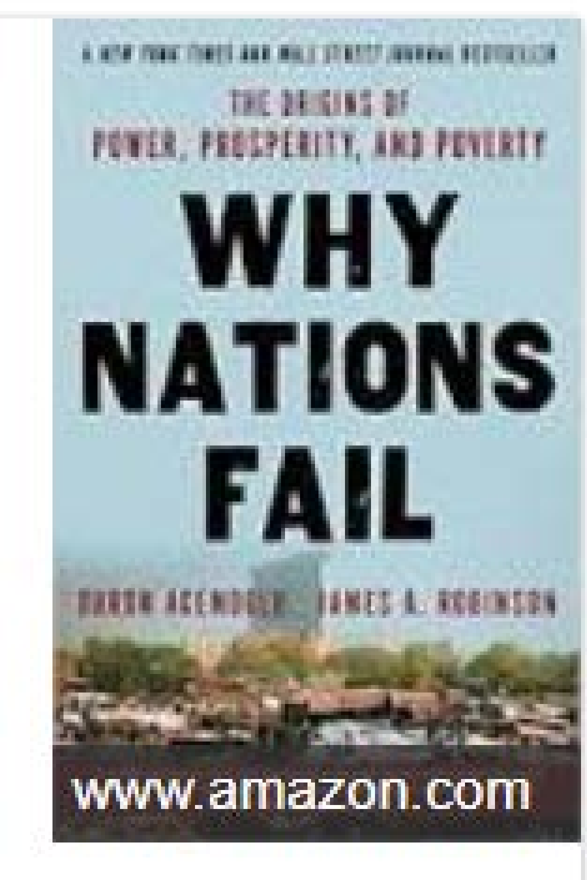
The key drivers for emerging markets—IT and consumerism—remain intact. EM companies have not only embraced the use of technology but have also become global innovators in many areas, ranging from e-commerce to mobile banking, robotics, autonomous vehicles and more. Rising wealth in emerging markets is another secular driver. Demand for goods and services should continue growing as incomes head higher. And as consumers meet their basic needs, aspirational wants usually follow. This “premiumization” trend could boost demand for high-end items such as luxury cars or for services such as entertainment and wealth management.

2. Volatile Currency Markets and EMs

See the following

https://research.stlouisfed.org/publications/economic-synopses/2015/01/30/the-economic-fundamentals-of-emerging-market-volatility/

3. Inclusive vs. Exclusive Political Institutions



Why Nations Fail: The Origins of Power, Prosperity, and Poverty, first published in 2012, is a non-fiction book by Turkish-American economist Daron Acemoglu from the Massachusetts Institute of Technology and British political scientist James A. Robinson from the University of Chicago.

4. Risks for Emerging Markets – geopolitical, social, informational, liquidity risks

Foreign Exchange Rate Risk

Foreign investments in stocks and bonds will typically produce returns in the local currency. As a result, investors will have to convert this local currency back into their domestic currency. An American who purchases a Brazilian stock in Brazil will have to buy and sell the security using the Brazilian real.

Therefore, currency fluctuations can impact the total return of the investment. If, for example, the local value of a held stock increased by 5%, but the real depreciated by 10%, the investor will experience a net loss in terms of total returns when selling and converting back to U.S. dollars

Non-Normal Distribution

North American market returns arguably follow a pattern of normal distributions. As a result, financial models can be used to price derivatives and make somewhat accurate economic forecasts about the future of equity prices. Emerging market securities, on the other hand, cannot be valuated using the same type of mean-variance analysis. Also, because emerging markets are undergoing constant changes, it is almost impossible to utilize historical information in order to draw proper correlations between events and returns.

Lax Insider Trading Restrictions

Although most countries claim to enforce strict laws against insider trading, none has proved to be as rigorous as the U.S. in terms of prosecuting these practices. Insider trading and various forms of market manipulation introduce market inefficiencies, whereby equity prices will significantly deviate from their intrinsic value. Such a system can be subject to extreme speculation, and can also be heavily controlled by those holding privileged information.

Lack of Liquidity
Emerging markets are generally less liquid than those found in developed economies. This market imperfection results in higher broker fees and an increased level of price uncertainty. Investors who try to sell stocks in an illiquid market face substantial risks that their orders will not be filled at the current price, and the transactions will only go through at an unfavorable level.

Additionally, brokers will charge higher commissions, as they have to make more diligent efforts to find counterparties for trades. Illiquid markets prevent investors realizing the benefits of fast transactions.

Difficulty Raising Capital
A poorly developed banking system will prevent firms from having the access to financing that is required to grow their businesses. Attained capital will usually be issued at a high required rate of return, increasing the company's weighted average cost of capital (WACC). The major concern with having a high WACC is that fewer projects will produce a high enough return to yield a positive net present value. Therefore, financial systems found in developed nations do not allow companies to undertake a higher variety of profit-generating projects.

Poor Corporate Governance

A solid corporate governance structure within any organization is correlated with positive stock returns. Emerging markets sometimes have weaker corporate governance systems, whereby management, or even the government, has a greater voice in the firm than shareholders.

Furthermore, when countries have restrictions on corporate takeovers, management does not have the same level of incentive to perform in order to maintain job security. While corporate governance in the emerging markets has a long road to go before being considered fully effective by North American standards, many countries are showing improvements in this area in order to gain access to cheaper international financing.

Increased Chance of Bankruptcy

A poor system of checks and balances and weaker accounting audit procedures increase the chance of corporate bankruptcy. Of course, bankruptcy is common in every economy, but such risks are most common outside of the developed world. Within emerging markets, firms can more freely cook the books to give an extended picture of profitability. Once the corporation is exposed, it experiences a sudden drop in value.

Because emerging markets are viewed as being more risky, they have to issue bonds that pay higher interest rates. The increased debt burden further increases borrowing costs and strengthens the potential for bankruptcy. Still, this asset class has left much of its unstable past behind.

Political Risk

Political risk refers to uncertainty regarding adverse government actions and decisions. Developed nations tend to follow a free market discipline of low government intervention, whereas emerging market businesses are often privatized upon demand. Some additional factors that contribute to political risk are: possibility of war, tax increases, loss of subsidy, change of market policy, inability to control inflation and laws regarding resource extraction. Major political instability can also result in civil war and a shutdown of industry, as workers either refuse or are no longer able to do their jobs.