

# understanding emerging markets

## WHAT ARE THE EMERGING MARKETS?

Emerging markets are nations in the process of rapid growth and industrialisation and are defined as economies with low to middle per capita income. Currently, there are 28 emerging markets in the world, constituting approximately 80% of the global population which represents about 25% of the world's economy. These countries include Argentina, Brazil, Chile, China, Colombia, Czech Republic, Egypt, Hungary, India, Indonesia, Israel, Jordan, Korea, Malaysia, Mexico, Morocco, Pakistan, Peru, Philippines, Poland, Russia, South Africa, Taiwan, Thailand, Turkey and Venezuela.

## WHAT MAKES THEM DIFFERENT?

Emerging markets have four major characteristics. First, the Asian and Latin American markets are regional economic powerhouses with large populations, large resource bases and large home markets which can spur development in the countries around them. Second, they are transitional societies that are undertaking domestic economic and political reforms. They have adopted more open door policies to replace their previous state interventionist policies that failed to produce sustainable economic growth. Third, they are the world's fastest growing economies, contributing a great deal to the world's growth of trade. They are becoming more significant buyers of goods and services than the industrialised countries. Fourth, they are critical participants in the world's major political, economic, and social affairs.

In their effort to create a market economy and to ensure sustainable development, emerging markets still face big challenges that come from fundamental problems associated with their traditional economic and political systems. Another serious problem that those countries have to confront is controlling corruption, which impedes the development process. An even more challenging task for those countries is to

undertake structural reforms with their financial, legal and political systems, so as to provide a disciplined and stable economy that is relatively free of political disturbances and interference.

## WHY INVEST IN EMERGING MARKETS?

Most emerging markets stories revolve around commodities, infrastructure, exports and currency issues. Emerging markets are usually perceived as producers of manufactured goods (e.g. China) or as commodity suppliers (e.g. Brazil and Russia), with incomes too

the developed economies and are now the drivers of global growth, taking over from the US, and are set to contribute 70-75% of global growth.

Demographics are an important attraction for emerging markets. Household size, family structures, urbanisation, age structure, etc. drive consumer expenditure patterns. The relative wealth of the emerging markets' populations is increasing. As incomes rise, households have considerably more spending power over and above simply putting food on the table and a roof over their head. Emerging market populations have much better demographic characteristics than their developed country peers, which have aging and shrinking populations, are downsizing their homes, and are already highly urbanised.

Economic fundamentals such as current account/fiscal balances and government debt levels are better in the emerging world than those in the developed world. While the developed world has increased its indebtedness, debt levels in the emerging markets are low and savings ratios are high. Emerging

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low or savings rates too high to have a meaningful impact on global consumption. However, emerging markets have now become major consumers, particularly the huge markets of China and India, outstripping the US in their share of global consumption.

Emerging economies are less dependent on the developed world for growth than they were a few years ago. Strong demand from within their own growing economies, and trade with other growing emerging market countries (particularly China and India), make these economies much more self-sufficient. In recent years, the emerging economies have been growing 4% to 5% faster than



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market banks have had relatively few problems because of their relatively conservative lending policies and their economies generally do not face the prospect of a prolonged recovery period, as the developed economies work through the deleveraging process.

The three largest emerging consumer markets are China, Brazil and India. These markets currently are, or about to become, trillion dollar growth markets. China and India will be the two main players, given their vast populations. The Chinese development story is well documented. Its consumer market has been growing by 8% a year in the past decade. Indian incomes are projected to grow three-fold over the next 15 years, elevating India to become the world's fifth largest consumer market by 2025. Despite often being overlooked, Latin America is close on the Asian countries' heels. For a long time the perceived wisdom was that Latin America offers investors little apart from commodities, boom/bust cycles, defaults and political uncertainty. However, things have changed and Latin America, particularly Brazil, now has a rapidly growing consumer market.

## THE RISKS TO INVESTING IN THE EMERGING MARKETS

Investments in emerging markets come with much greater risk due to political instability, domestic infrastructure problems, currency volatility and limited equity opportunities. Emerging markets remain significantly more volatile compared to the developed markets in the US, UK, Europe and Japan. While volatility within the emerging markets has

indeed diminished significantly during the past decade after the wild gyrations in the 1990s, investors should still be aware of the additional risk that this higher volatility will have on their portfolios.

Emerging markets generally do not have the level of market efficiency and the same standards in accounting and securities regulation as with the advanced economies. This creates a lack of transparency and additional risk for investors. Although emerging markets will typically have a physical financial infrastructure including banks, a stock exchange and a unified currency, local stock exchanges may not offer fully liquid markets for outside investors.

An emerging market economy must have to weigh local political and social factors as it attempts to open up its economy to the world. This creates sovereign risk. Citizens who are accustomed to being protected from the outside world can often be distrustful of foreign investment and may be opposed to having foreigners own parts of the local economy. Panic and speculation are also more common. The 1997 Asian crisis, during which international capital flows into these countries actually began to reverse themselves, is a good example of how emerging markets can be high-risk investment opportunities.

The process of 'emergence' may be difficult and fraught at times. Countries emerging from one way of life to another, from the agrarian to the urban, will encounter stresses and strains along the way. It should not be forgotten that significant numbers of their citizens remain poor or vulnerable. In developing countries even small economic disloca-

tions can provoke substantial challenges. When jobs are lost, where corruption flourishes, when remittances are cut off and when food prices soar, poverty will increase and social tensions will worsen. This is particularly true where income disparities are large and there are still sizeable pockets of poverty.

## CONCLUSION

We believe there is a compelling case for including emerging markets within a diversified portfolio for growth-oriented investors. Although emerging economies may be able to look forward to brighter opportunities and offer new areas of investment for foreign and developed economies, investors need to be fully aware of the risks.

Emerging markets are the key factor in the future growth of world trade and global financial stability, and they will become critical players in global politics. They have a huge untapped potential and are determined to undertake domestic reforms to support sustainable economic growth. If they can maintain political stability and succeed with their structural reforms, their future is promising.



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