OPPORTUNITIES IN EMERGING MARKETS

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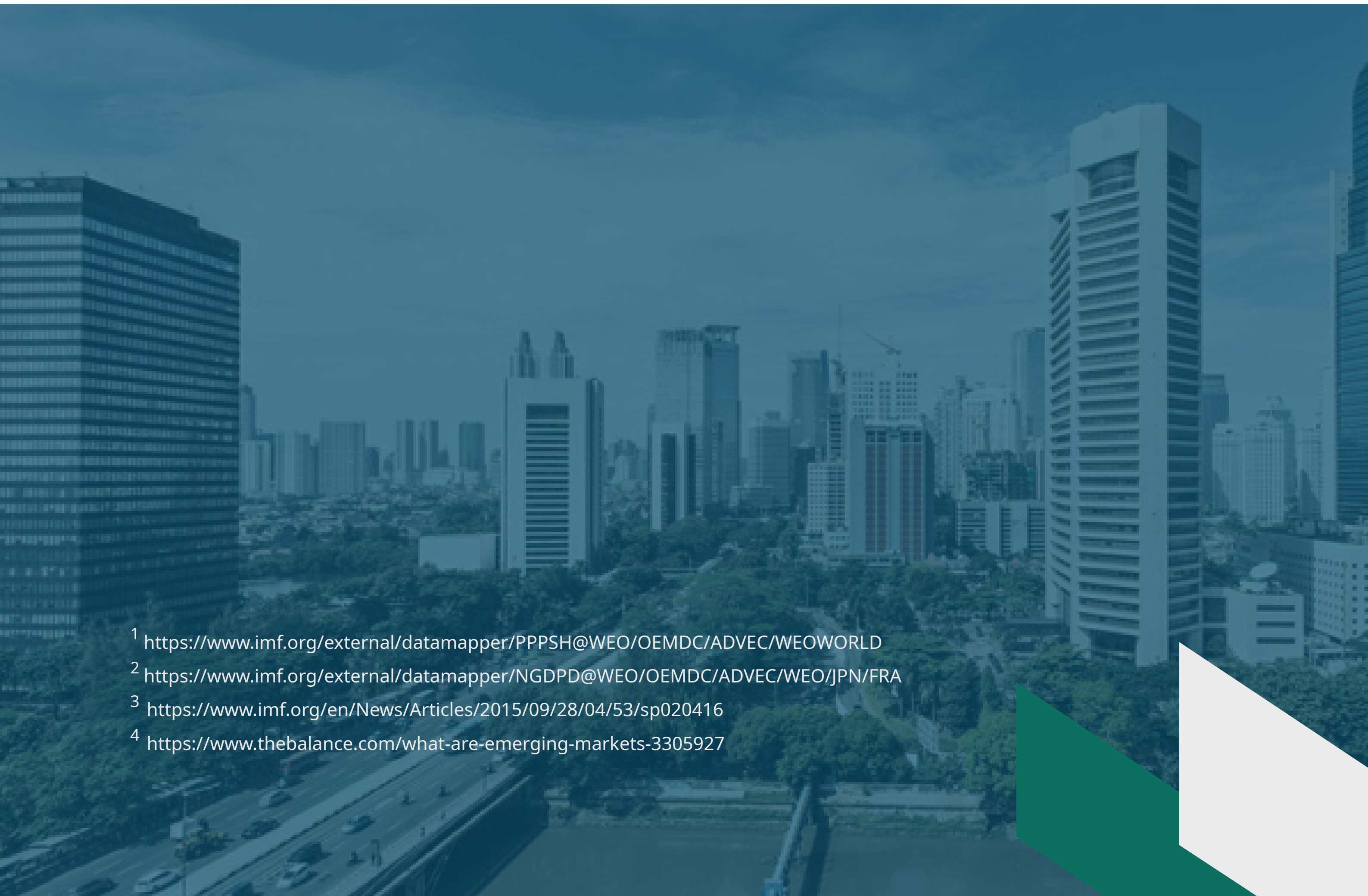
Introduction

Emerging markets have transformed remarkably since the turn of the millennium. Major geo-political, economic and demographic changes have influenced countries and companies in these economies and made them popular investment hubs for forex and equity traders alike. According to the IMF, as a group, the emerging economies accounted for almost 60% of the global GDP by 2017[1], doubling their contribution since 2007[2].

Since the 2008 financial crisis, these markets have contributed to more than 80% of global growth[3], creating a significant number of jobs in advanced economies too. A report by the World Bank, published in 2012, stated that emerging markets alone had been the main driver for the huge reduction in global poverty levels, particularly in countries like China and India.

What are Emerging Markets?

A broad range of countries across different geographies make up the emerging markets. The World Bank defines them as countries with per capita income of less than $4,035[4]. They are perceived as a group of economies with strong potential for growth and, in turn, strong potential for investment returns, keeping in mind all the political, counterparty, legal and operational risks. Over the years, they have gradually moved away from their traditional agricultural and commodity-based economies towards a more export-based GDP growth. Leaders of these countries have concentrated on rapid industrialisation and adopted a free or mixed market economy.



[1] https://www.imf.org/external/datamapper/PPPSH@WEO/OEMDC/ADVEC/WEOWORLD
[2] https://www.imf.org/external/datamapper/NGDPD@WEO/OEMDC/ADVEC/WEO/JPN/FRA
[3] https://www.imf.org/en/News/Articles/2015/09/28/04/53/sp020416
[4] https://www.thebalance.com/what-are-emerging-markets-3305927

MSCI Emerging Markets Index

The MSCI Emerging Markets Index, a measure of stock market performance in selected areas, lists 26 countries in the emerging markets category, including Brazil, China, Malaysia, Colombia, India, Czech Republic, UAE, Singapore, Saudi Arabia, Hong Kong, Kuwait, Thailand and South Africa. The index tracks the market capitalisation of every company listed on the stock exchanges of these countries, prominent among them being the Asian stock markets like China, Taiwan and India.

Together, China and India accounted for 40% of the global labour force and population in 2006[5]. The combined economic output of the two Asian nations stood at 32.6 trillion in 2017, which was much greater than that of the European Union[6]. Other Asian economies, like Taiwan and South Korea, are significant index countries with weights of 15% and 12% on the MSCI Emerging Markets Index, respectively[7].

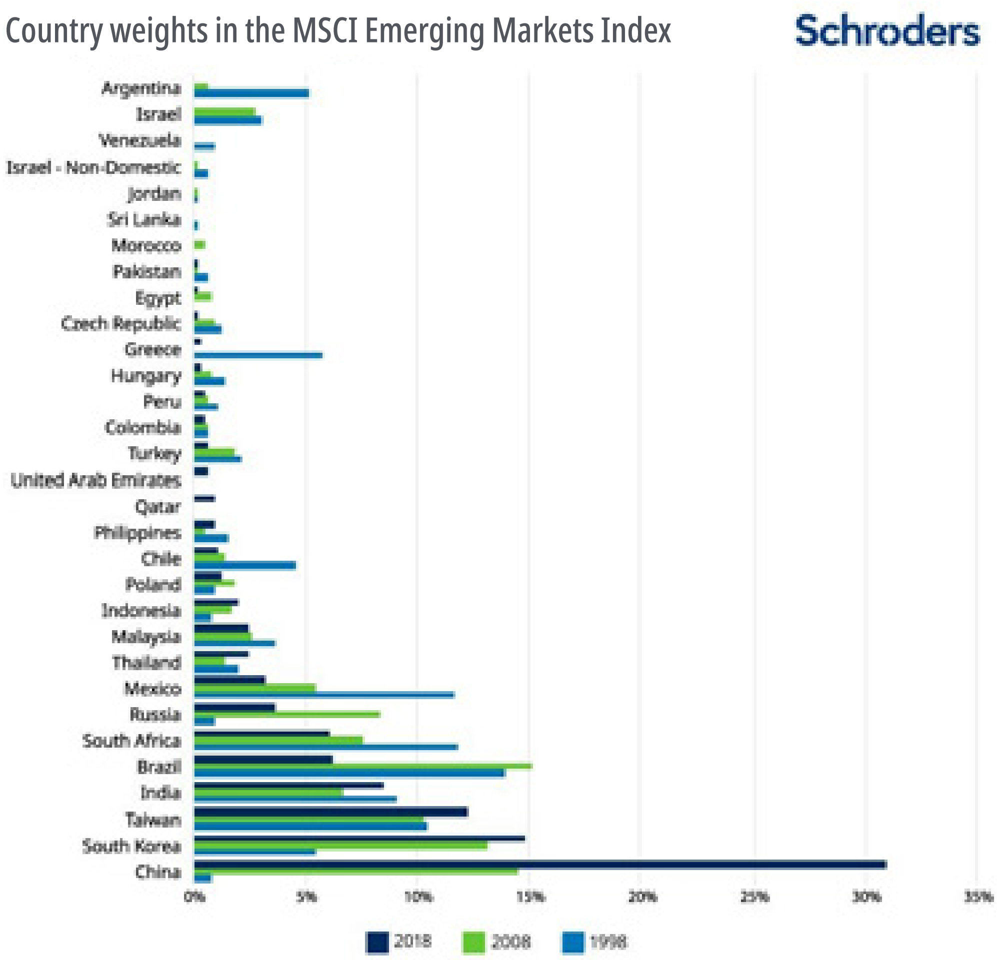


Image Source: https://www.schroders.com/en/insights/economics/how-emerging-markets-have-changed-over-the-past-20-years/

[5] https://www.ecb.europa.eu/pub/pdf/scpops/ecbocp80.pdf?4dc905763ba04c9ad7991b81462c8af6
[6] https://www.investopedia.com/insights/worlds-top-economies/
[7] https://www.schroders.com/en/insights/economics/how-emerging-markets-have-changed-over-the-past-20-years/

Why Invest in Emerging Markets?

Emerging markets (EM) are considered to potentially have good long-term growth opportunities, but the risks and volatility could be high too. While risks might be mitigated with sound technical and fundamental analysis and appropriate risk management tools, volatility could offer valuable entry points for informed and disciplined investors.

NOTE

Rapid social changes like natural disasters, political instability and external price shocks in emerging economies gives EM stocks high volatility, but also opportunity. Markets are highly prone to violent currency swings (involving US Dollar) and commodities swings (oil).

Technical indicators like volatility index can help navigate the trends.

1 They Have Shown Resilience Through the Global Financial Crisis

Using a large set of policy tools, emerging nations were able to fare better through the 2008 economic recession, as compared to their developed counterparts. Studies have shown how they managed to counter small GDP growth during the crisis years, after taking account of the usual controls.

For instance, by September 2009, the emerging economies were able to attain pre-crisis levels of industrial production, which advanced economies were still struggling with, continuing below their pre-crisis levels even in January 2010.

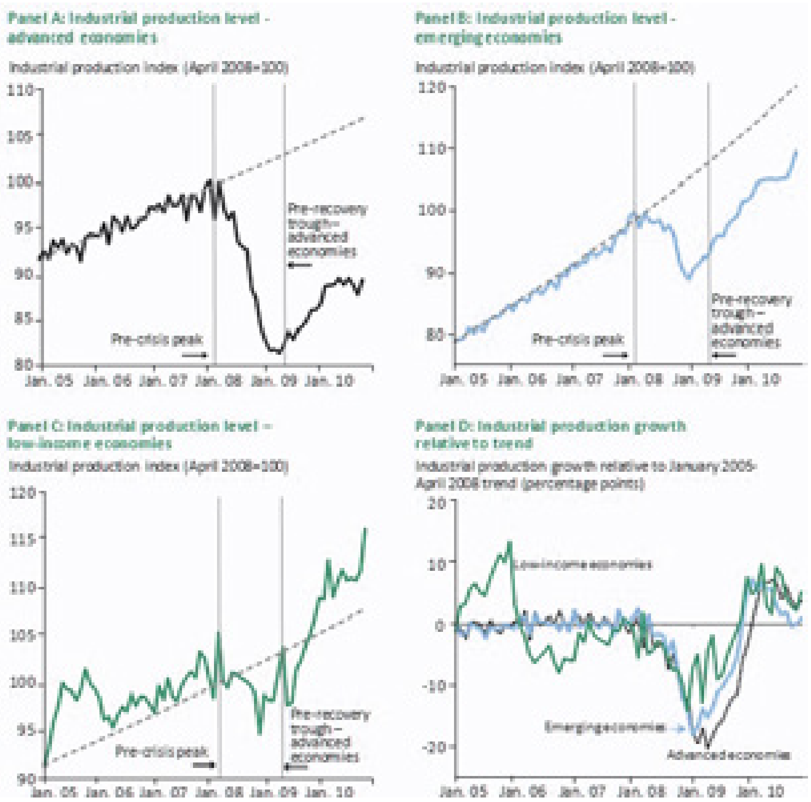


Image Source: https://voxeu.org/article/resilience-emerging-markets-during-global-crisis

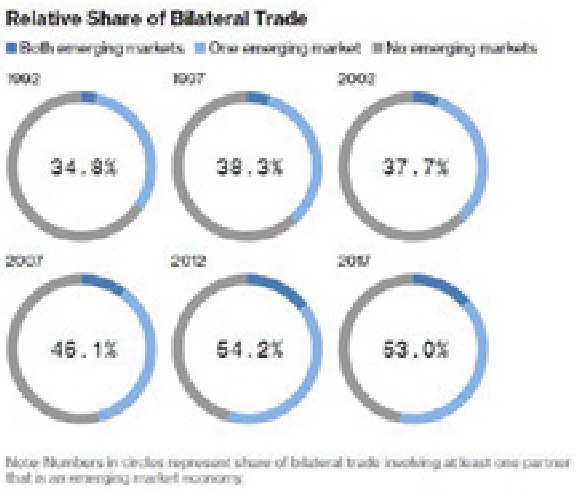
2 Significant Amount of Global Trade Passes Through Emerging Economies

Until the end of the 20th century, 62% of bilateral trade was between rich nations, such as the US, Canada and Europe. By the end of the second decade of the 21st century, UN Comtrade data showed that these nations' share stood at 47%, with developing nations becoming more significant trading partners[8]. For instance, 53% of bilateral trade in 2018 involved at least one emerging market, as compared to 38% in 1997[9].

There are some key patterns observed here:

- Asia is a huge market base for Latin American beef and coffee, especially China, which consumes 29% of the agricultural exports from Latin America.
- South Africa's mining industry (minerals and precious metals) exports primarily to 4 major nations, with China, India, Botswana and Mozambique accounting for 40% of its export base.
- The OPEC countries export 45% of their crude to emerging markets, particularly India, whose rapid economic growth since the turn of the century increased its energy appetite, placing it second only to the US by 2019.
- China's neighbouring countries, including India, South Korea and Vietnam, account for 28% of its exports in electronic goods[10].

In every case, the US and Japan have seen drastic decline in demand for their products from emerging countries. This indicates that the emerging economies have worked to reduce their reliance on wealthy nations.



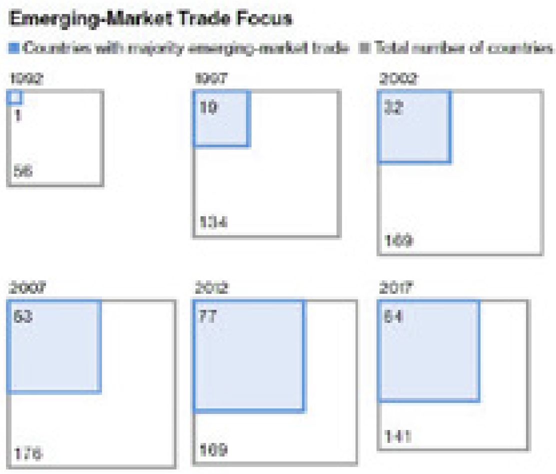


Image Source: https://www.bloomberg.com/graphics/2019-bloomberg-new-economy/global-trade-developing-nations/

8 https://www.bloomberg.com/graphics/2019-bloomberg-new-economy/global-trade-developing-nations/
9 https://safety4sea.com/global-trade-changes-in-light-of-developing-countries/
10 https://safety4sea.com/global-trade-changes-in-light-of-developing-countries/

3 Global Liquidity Shifts Driving These Markets

Investing in emerging market equities requires a thorough understanding of global liquidity cycles. Some factors to consider here are:

- The financial world is largely US dollar-based, which means the fiscal and monetary policies of the United States have a great influence on global capital flow.
- In times of heightened economic and political crisis in other parts of the world, the US markets are considered “safe-havens” due to the presence of high liquidity and proper rule of law. This draws large amounts of funds into the US financial systems.
- Emerging markets experience shorter and sharper cycles than the US.

When liquidity contracts and interest rates rise in the US, it attracts capital and the US dollar appreciates. This means money flows away from emerging markets. On the other hand, when liquidity is expanding and interest rates are steady or in a decline in countries like the US and UK, investors globally go looking for higher returns in emerging economies. These economies grow as a result and cost of debt declines, while local currencies appreciate.

The US Federal Reserve adopted a dovish stance in 2018, while the ECB paused its monetary normalisation and China increasingly showed a tendency for fiscal-driven reflation. This proved favourable for emerging market stocks.

4 Twice the Annual GDP Growth of Developed Economies

Emerging markets witness faster overall growth rate, as compared to the slow developing wealthy nations. This is why the former has increasingly occupied a significant share of the world's market capitalisation.

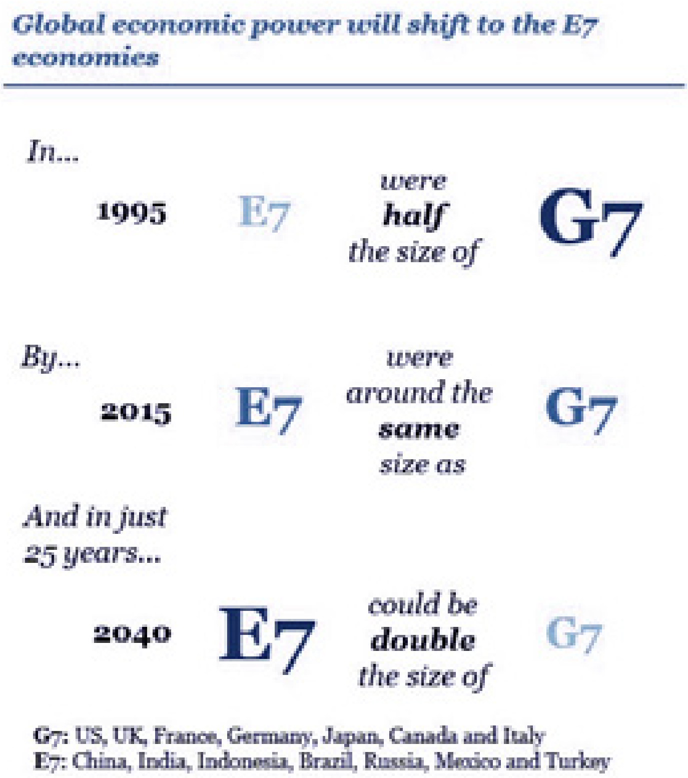


Image Source: https://www.pwc.com/gx/en/issues/economy/the-world-in-2050.html

How to Invest in Emerging Markets?

Investors in emerging markets face different types of risks than those who invest in developed economies. Choosing the right stocks and economic sectors to invest in requires a thorough understanding of the environment in which the companies in these countries operate.

Characteristics of Emerging Markets

- Lower–than-average per-capita income: This provides stimulus for rapid economic growth.
- High volatility: Highly prone to unstable regimes, natural disasters, changes in regulatory policies and external factors.
- Growth comes at a price: Rapid industrialization causes some sectors to suffer; like farmers and the rural population. Investors may face losses where governments default on debt or social unrest occurs.
- Capital markets are not mature: It is difficult to gain information about companies listed on the stock markets of emerging nations. Although the rise in FDI has led to the development of these markets.
- High risk/High returns: Companies that produce low cost consumer goods and commodities for developed markets tend to have high stock prices. It also means potentially higher returns on corporate bonds.

Emerging Market Currencies

The reason emerging market currencies might be appealing is that they are prone to greater volatility than the major currencies, which means more trading opportunities. However, it is also important to remember that these currencies come with their own risks. For instance, geo-political risks are often associated with emerging economies, which would lead to greater uncertainties for the FX market.

Another key aspect of these currencies is that unlike the currencies of developed nations, they tend to be pegged to a foreign currency, rather than being allowed to float freely. The most common foreign currency that emerging market currencies are pegged to is the US Dollar.

	Emerging Market Currencies	Developed Nation Currencies [11]
Liquidity	Moderate	High
Historical Volatility	High	Low
Transaction Costs / Spread	High	Low
Slippage	High Risk	Low Risk

The top 5 emerging market currencies include:

1. Mexican Peso – USD/MXN
2. Russian Ruble – USD/RUB
3. Indian Rupee – USD/INR
4. Chinese Yuan – Both CNH and CNY
5. South African Rand – USD/ZAR

NOTE

To trade emerging market currencies, you should consider staying up to date with up-coming political events and economic releases which could lead to volatility.

[11] https://www.dailyfx.com/forex/education/trading_tips/daily_trading_lesson/2019/01/16/emerging-market-currencies.html

Trading Strategies for Emerging Markets

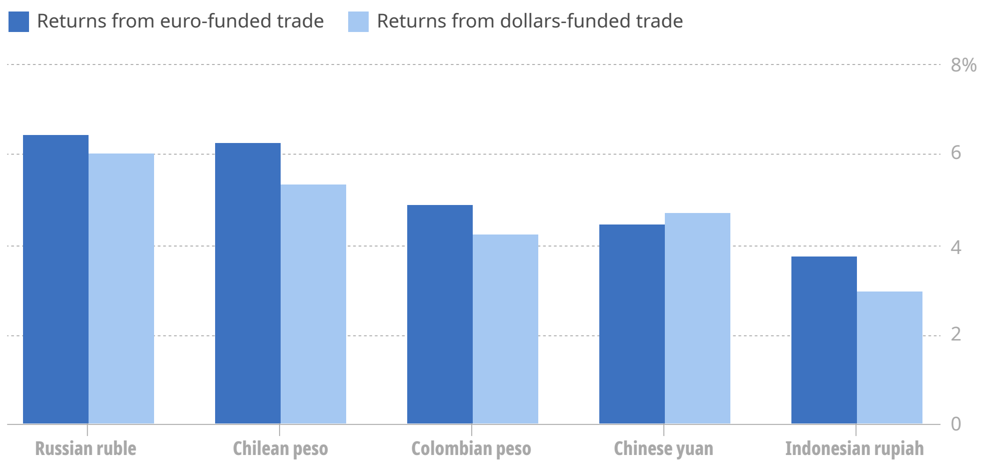
A popular trading strategy for the emerging markets is carry trade, where traders try to capture positive interest rate differentials between a high-yielding currency and a low yielding one. Emerging markets usually offer much higher interest rates than developed economies. So, one can benefit from interest rate differentials by going long on the currency of an emerging market, while going short on the currency of a developed country. While the interest earned may be very low, leverage can make it quite substantial. What one should keep in mind, however, is that currencies of emerging countries are volatile and a change in the exchange rate may completely wipe out the interest earned.

NOTE

Carry trading strategies have continued to work in favour of emerging market currencies. These have reduced domestic bond yields and attracted strong inflows into emerging market equities.

Looking for Carry

Using the euro to buy emerging-market currencies has mostly been more profitable



Note: Returns are adjusted for price fluctuations for this year through Feb. 28
Source: Bloomberg

Image Source: https://www.bloomberg.com/news/articles/2019-02-28/euro-funded-carry-trades-for-emerging-markets-are-back-in-vogue

In 2014, the Euro fell 12% against the US Dollar, going on to depreciate a further 9% by August 2015[12]. As a result of low interest rates in the Eurozone, capital inflows into emerging markets increased. However, as doubts regarding the Chinese economy re-surfaced, this capital went back to Europe, leading to the strengthening of the Euro. Euro-funded carry trade strategies began to see popularity, which led to the further appreciation of the Euro.

[12] https://www.livemint.com/Money/xvm32SoHrbEjjMGpsbBKSM/Euro-and-the-emerging-markets-carry-trade-unwinding.html

OPEN LIVE ACCOUNT

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73% of Retail investor accounts lose money when trading CFDs and Spreadbets with this provider.
You should consider whether you understand how CFDs work and whether you can afford to take the high risk of losing your money.

Risk Warning:

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