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Buttonwood

The third wave

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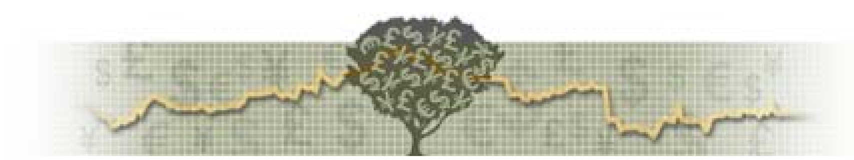
This time, emerging markets are for real



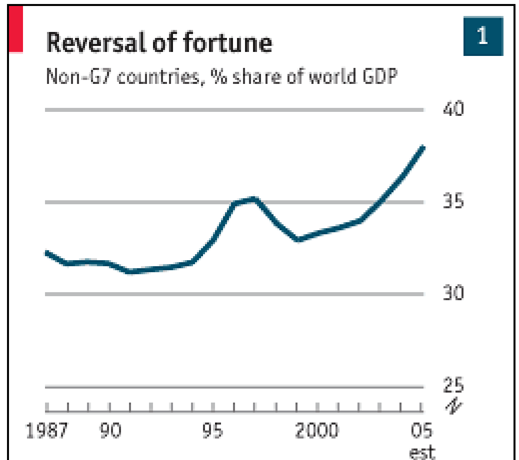
HERE is an arresting little flake from this week's blizzard of news: Hugo Chávez—president of Venezuela, self-styled leader of the Bolívarian populist revolution, scourge of American imperialism and its capitalist lackeys—is about to start repaying those lackeys debts that have their roots in the Latin American debt crisis of the early 1980s. Venezuela has just announced that it will retire almost $4 billion of "Brady bonds". These securities, named in 1989 after Nicholas Brady, then America's Treasury Secretary, were the instruments by which Latin American governments repackaged tens of billions of dollars of defaulted loans from western commercial banks flush with petrodollars in the 1970s.

Because the bonds allowed the banks to get back at least a handful of cents on the dollar, the Brady plan drew a line under the first emerging-market crisis since the second world war. But because the plan also raised emerging-market borrowers from pariah status, it helped grease the skids for the second lot of emerging-market crises involving fresh inflows of foreign money, notably Mexico's Tequila crisis of 1994, the Asian financial crisis of 1997-98, Russia's default in 1998, Argentina's devaluation and default in 2001-02 and Brazil's currency woes soon after.

Venezuela's early repayment is a mark of how far the world has come since. Mexico, which issued the first Brady bonds, paid its stock off in full in 2003. Last week Brazil said that it too would buy back all its remaining $6.6 billion pile. The improvement in emerging-markets' reputation has been staggering. In 2002, at the height of the Brazilian crisis, emerging-market bonds worldwide, measured by J.P. Morgan's EMBI+ index, traded at yields of more than 900 basis points (ie, nine percentage points) over equivalent American Treasury bonds. This week, the spread dipped to a record low, under 200 basis points. The spread on Brazilian debt has shrunk, to a bit more than 200 points, less than a tenth of what it was. Someone has made an awful lot of money.

It is, indeed, increasingly clear that rich-world financiers are surfing a third post-war wave of investment in emerging markets. That has already led people to predict consequences as abrupt and as unpleasant as when the first two hit the shore. And perhaps Egyptian debt, which changes hands at a mere 40 basis points above Treasuries, is priced rather too exquisitely for perfection. On the other hand, the contention that emerging-market equities offer real long-term value is a much stronger one.

Richard Cookson, a former incarnation of Buttonwood who now leads a respectable life as global head of asset allocation at HSBC in London, argues that private capital flows to emerging markets (both portfolio and foreign direct investment) are still meagre, compared with the first two investment waves. When they peaked in 1996, net private capital inflows were equivalent to 3.5% of receiving countries' GDP. The figure fell to just 1.6% of GDP in 1999 and rose to only 1.7% by 2004—though the figure is likely to be higher today.



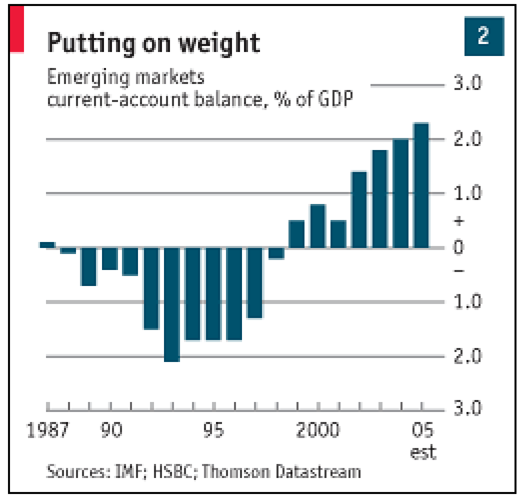
Sources: World Bank; OECD; HSBC; Thomson Datastream

Set against the great age of truly global investment in the late 19th and early 20th centuries, which came to a shattering end with the first world war, both the stock and flow of international investment in emerging economies is still derisorily small, even if the stock of international investment as a proportion of global GDP is much higher. In 1913, says Moritz Schularick, an economic historian, 40-50% of international investments were in countries with incomes per head less than one-third of those in the richest economies, while nine of the top 12 recipients of foreign capital were not industrialised countries. Today, non-OECD countries account for less than one-sixth of the stock of international investments. Only one economy (China's) among the top dozen recipients of foreign capital qualifies as emerging.

This is of more than academic interest, Mr Cookson argues, because a secular trend appears to be under way in which emerging economies account for a growing share of world GDP (see chart 1). Those economies have been strong lately, most visibly thanks to high energy and commodity prices. These underpin both Latin America's resilience and Russia's. There has been a lot of rich-world fretting about such high prices. But a big part of the fresh demand for oil and commodities comes from other emerging markets, notably China, India and much of the rest of Asia. These consumers of commodities are growing powerfully: China at 10%, India at 7%, South-East Asia's big economies at over 5%. High commodity prices, in other words, are symptomatic of emerging-economy strength.

That strength, crucially, has been underpinned since the late 1990s by sounder finances. Crisis and its contagion are now constrained by current-account surpluses, where once big deficits gaped (see chart 2), and by fat and growing foreign-exchange reserves. Plenty of concerns can be found—China's creaky banking system, India's chronic infrastructure and uncomfortably high inflation—but Mr Cookson is surely right when he says that, on the whole, "emerging markets are more stable than they were". And, this Buttonwood will add, in most of them equities are far from richly valued.

But just as any prudent investor a century ago, wishing both to boost his returns and spread his risk, should have been deeply invested in relatively poor countries, so he should also have withdrawn every penny before August 1914. What risks today lie in wait for the modern global investor? Political risk is there, for sure. Indeed, in the region where this columnist sits, few pundits, not least *The Economist*'s, were predicting a week ago that by Friday an election would be called in Thailand and a state of emergency declared in the Philippines. Political risk?, some hardened investors will ask in disbelief; a buying opportunity, more like.



The chief geopolitical risk, which Mr Cookson underscores, is a longer-term one, but a process already under way: the very strength of emerging economies is altering power relations among states. The uppitiness of Mr Chávez, the growling of the Russian bear and even Iran's nuclear-tipped ambitions have all surely been reinforced by high energy prices. Emerging markets are producing emerging (or re-emerging) powers, notably Russia and China. Before 1914, Britain was the superpower that policed the global economic system. Today, the prospect is not altogether bright that the United States, its goodwill and resources depleted by Iraq and other cares, will play the same role. So rivalry, disputes and sometimes alarming tensions are bound to colour this latest and most powerful emerging-market trend.

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