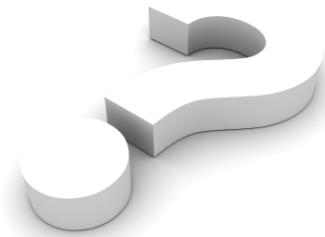


## The Decoupling Dilemma

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**Although a hot topic throughout most of 2008, decoupling faded away last autumn as emerging markets collapsed. Among the most pessimistic claims was the idea that it makes no sense to discuss decoupling in an era of globalisation that is increasingly synchronizing business cycles. Supporting this view was the sharp rise in emerging market bond yield spreads and a decline in emerging equities up until the end of the first quarter of 2009.**



### So where are we now?

There's a distinction to be made between economic and market decoupling. Those who argue that economic decoupling between emerging markets economies and the US can't possibly happen are forgetting that it already has.

Economic decoupling doesn't mean that a global recession would have no impact on the economies of developing countries. Instead it implies that their gross domestic product growth rates would slow much less than in previous US downturns, yet still be much higher than those Europe, Japan the United Kingdom and even the United States. The European Central Bank is forecasting a decline in EU growth of 4 percent to 5 percent this year and another 1 percent decline next year. In contrast, most of the larger emerging economies are expected to grow in the 3 percent to 6 percent range.

One reason for this disparity is that while exports to the US have declined, those to other emerging economies have surged dramatically. Half of China's exports now go to other emerging economies. Likewise, although South Korea's exports to the United States tumbled, they surged overall thanks to increased trade with other developing nations.

An additional supporting factor was the quickening domestic consumption and investment in many emerging markets throughout 2008. Consumer spending accelerated almost three times faster than that of the developed world, boosted by higher employment and credit penetration. For example, retail sales for the emerging market aggregate never dipped into negative territory even at the height of the crisis during the first quarter of 2009. Investments held up as well, buttressed by large government infrastructure spending.

Emerging economies also appear much sounder than those of developed countries on many fronts such as government debt and external balances. For example, China and Brazil, have been able to make full use of monetary and fiscal policy to cushion their economies. In the past, when they were net foreign borrowers, capital inflows tended to dry up during global downturns, forcing governments to raise interest rates and tighten fiscal policy to prevent capital outflows, often making matter worse.

Equity markets, on the other hand, tend to be more closely related to global developments partly because the companies included are increasingly internationally focused than the overall economies and partly because equity markets are often moved by global risk appetite.

As of the end of August, the MSCI Emerging Market index has risen over 100 percent from its low and 48.5 percent year to date, thus recouping all of the falls relative to developed markets (in comparison, the Standard and Poor 500 index has risen half of that from its low and 12 percent year to date).

Whether it is right or wrong, the emerging markets are still acting like a high-risk version of the US equity market. The peaks and troughs of the US market correspond almost exactly to the extremes of the relative performance of emerging markets.

The inability of financial markets to decouple in the short term does not mean that the asset class should be considered simply a higher risk play on developed markets. Non-developed economies account for 85 percent of the global population, 75 percent of global land mass and 70 percent of global foreign exchange reserves, yet for only 8 percent of global market capitalisation. On top of that, emerging markets equities, notwithstanding the relative strong out-performance of the last couple of months, still trade at a 20 percent discount or more to the S&P 500.

Despite the short-term volatility of global equity markets, in the medium to long term, emerging markets' capitalisation will rise substantially from their current levels. The last decade has witnessed an underlying secular improvement in developing economies as reflected in the doubling of the MSCI Emerging Market index (+90 percent since 1998), compared to a fall of 35 percent in the S&P500 index over the same period. This uptrend has been driven by a combination of fast economic growth and steady improvement in emerging corporate return on equity (emerging companies' return on equity were half those of developed markets a decade ago; today they are approximately the same).

Emerging market equities will remain at the mercy of trends in developed markets in the short term, but in the medium to long term (periods over three years) trends in economies, which can decouple, are more important. Over that time scale, decoupling is alive and well.

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