

Emerging markets: what does the recent poor performance indicate?

The emerging countries' equity and bond markets have put in a mediocre and, in some cases, very poor performance over the past few months. The ING Barings "Emerging World" Index denominated in dollars has fallen by 27% since the end of March 2000, thus wiping out more than half of the gains registered since the Russian crisis (+104% between end-August 1998 and end-March 2000). The average spread associated with the JP Morgan EMBI+ index has been on a rising trajectory again since early September, reaching 755 bp in mid-November, after an almost continuous improvement since August 1999.

When these recent developments are viewed in the longer-term perspective, this fall on the bond and equity markets gives pause for serious thought. Over the last six years the performance of the emerging markets has been characterised by surges abruptly terminated by major economic or financial crises, such as the Mexican crisis at the end of 1994, the Asian crisis in 1997-98, followed by the Russian and Brazilian crises in 1998-99.



Macroeconomic conditions in the developing countries have, on average, improved appreciably since 1997-98.

In spite of favourable overall fundamentals, emerging countries remain vulnerable

Emerging countries, Nasdaq: the substitution possibilities of risky assets

If we examine the main macroeconomic indicators for the developing countries, it is evident that the situation is much better than it has been for several years. Growth is strong and not causing any excessive external imbalance and the overall external solvency indicators have improved, leading Standard & Poor's, for example, to upgrade sovereign debt in 29 cases over the past twelve months.

Nevertheless, beyond these positive global developments, in each of the major geographical areas trends are occurring that are worrying for international investors. These include failures among the South Korean "chaebols", political tensions in the Philippines and Indonesia, military tension in the Middle East, political unrest in the Andean countries, institutional problems in Russia, and so on. True, these factors are not sufficient in themselves to trigger an actual macroeconomic turnaround, but they feed doubts about the medium-term sustainability of the current performance, at a time when the key factors determining the international environment for the developing countries have become less favourable. At the end of 2000, growth forecasts are pointing downwards and US interest rates are still high, which is the worst possible combination.

The growing integration of emerging markets into a broader category of "risky" assets, combined with a change in investors' perceptions of the overall portfolio risk, makes it easier to understand recent developments.

The years 1998-2000 have seen a relative drying-up of funds dedicated to the emerging markets and the development of portfolio management strategies that identify a weighting to be assigned to "risky assets" of any kind. The instruments issued by the emerging markets have therefore become one of several other kinds of investment designed to increase the expected returns on portfolios, alongside technology or even cyclical stocks and high-yield bonds issued by companies in the industrialised countries. In this context, the positive performance of the emerging markets up to the turnarounds observed in 2000 has been accompanied by a growing appetite on the part of investors for risky assets in an essentially "euphoric" environment that contains the seeds of a future backlash.

As far as equity markets are concerned, this situation was compounded by the fact that TMT stocks make up a particularly large proportion of the Asian countries' benchmark indices, while the Asian markets themselves occupy a dominant position among "emerging equities" generally. Thus, a wholesale move out of technology stocks has a direct impact on trends in emerging stock market indices, reinforcing the link with Nasdaq. On the bond markets, the transmission process takes place between the high-yield segment and international bonds issued on the emerging markets. Here too the increased risk, evidenced by the spectacular rise in the US since 1998 in the default rate on high-yield bonds, has led, since the end of the summer, to increased investor mistrust of emerging countries' instruments, following an abnormal tightening of spreads between speculative US paper and emerging countries' bonds during most of 2000. Once again, it is investors' rational financial decisions and switching activity in response to their overall perception of risk that are at work.

Argentina: a real risk of contagion

Finally, the concentration of risks on a few countries of major importance to the markets, especially Argentina, is creating conditions in which doubts can infect the whole category of risky assets.

The situation in Argentina is a major source of worry among international investors. Given the relative size of external debt, the recurring need for additional external finance, the weakness of the growth rate and the exceptionally limited scope for action on the economic policy front, questions are being raised as to whether the country will be able to balance its books in 2001 and 2002. Since Argentina is the main issuer on the emerging bond markets, these doubts are having a markedly negative influence on this category of assets in general. When taken in conjunction with the preceding analysis, this situation suggests that there is the risk of a "self-fulfilling" crisis developing in Argentina if international operators engage in switching that is intrinsically hostile to risky securities and if such a withdrawal of funds makes it impossible for Argentina to sort out its finances.

Against this background, future developments will depend both on how international investors (particularly in the US) generally perceive the financial risk and how far the developing countries are able to reduce their dependence on external financial assistance.

Towards more investor risk aversion

It is unlikely that we shall see a significant reduction in risk aversion in the short term. The move out of risky assets will therefore automatically weigh on the performance of emerging equity and bond markets, even if the overall fundamentals for such assets are better than they have been over the past two years. If it is assumed that the stock market correction in technology stocks will come to an end, it follows that the stock markets of the emerging countries could outperform the bond markets, especially if the slowdown in the US leads to a greater number of defaults by companies rated as "speculative". It is also likely that we shall see a widening of the gap between countries, with Mexico, Poland or Turkey, say, showing greater vulnerability than China, South Korea or Chile, given their respective external financing needs in 2001.

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This bulletin went to press on November 17, 2000
Articles may be reproduced with attribution
Dépôt légal: 1999 - ISSN: 1291-2425 - Photograph: Dimitri Tolstoi
Production: Phénix Communication (tel. 33 (1) 49 64 64 64)



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