INTERNATIONAL: Global risk perceptions may shift

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**Abstract (summary)**

Dangers arising from an overly abrupt repricing of risk in developing markets.

In the aftermath of the 2008-09 global financial crisis many prominent portfolio managers and institutional investors came to believe that the global risk landscape had undergone a permanent shift. Developing economies would experience stronger and more stable growth than in the recent past; rich countries would be mired in a prolonged period of sluggish expansion and relative political instability. This shift has, in fact, developed -- with certain notable exceptions. Yet investors are now increasingly concerned this state of affairs may be more temporary than many initially believed, and that a sudden bout of capital flight from the emerging world might lead to serious global financial instability.

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**Full Text**

**SUBJECT:** Dangers arising from an overly abrupt repricing of risk in developing markets.

**SIGNIFICANCE:** In the aftermath of the 2008-09 global financial crisis many prominent portfolio managers and institutional investors came to believe that the global risk landscape had undergone a permanent shift. Developing economies would experience stronger and more stable growth than in the recent past; rich countries would be mired in a prolonged period of sluggish expansion and relative political instability. This shift has, in fact, developed -- with certain notable exceptions. Yet investors are now increasingly concerned this state of affairs may be more temporary than many initially believed, and that a sudden bout of capital flight from the emerging world might lead to serious global financial instability.

**ANALYSIS:** Impacts.

Many investors remain overly focused on conditions relevant in the 2008 crisis -- exposing them to new risks.
Active managers have boosted the emerging-markets weighting of their portfolios, increasing their vulnerability in the event of a crisis.

An emerging markets crisis could disrupt global supply chains; many global businesses have inadequate contingency plans.

In 2009, Mohamed El-Erian, CEO of Pimco -- the California-based global asset manager -- declared that the global economy had entered a 'new normal' defined by a significant shift in the balance of global risks:

Developed economies had supposedly downshifted to a new, much lower, growth trend -- which would produce a significant rise in relative political risk and unrest.

At the same time, emerging economies -- powered by demand for raw materials and consumer goods in China -- would be able to shrug off slower growth in rich economies, expand strongly, and create more stable political institutions.

Consequently, many investors bet heavily on stronger, more stable growth in the developing world, which has paid off handsomely. Yet doubts are beginning to emerge about the durability of this 'upside-down' paradigm -- where emerging economies exhibit both higher growth and lower volatility.

Storm signals?.

There are three key reasons why emerging markets may witness greater volatility in the next decade than they have in the last ten years:

End of 'cheap money'.

The financial crisis led to extraordinary monetary easing by rich world central banks slashing interest rates. This led many investors to look abroad in a 'hunt for yield', and fed a wave of welcome investment in emerging economies, particularly in infrastructure and extractive sectors. Eventually, increasingly prosperous firms based in developing countries also began to look abroad for growth -- often in other emerging economies -- and used cheap credit and robust local currency appreciation to fuel expansion via foreign-currency denominated loans.

Yet the end of this cycle is already on the horizon. As US growth picks up, the Federal Reserve has begun contemplating a reduction in its monthly asset purchases through quantitative easing (QE 'tapering'). Fed Chairman Ben Bernanke's mention of this prospective shift in May caused a significant selloff in emerging market assets, and a spectacular fall in local currencies against the dollar (particularly in India).

Less commodity-driven growth.

Although oil prices remain buoyant, the metals cycle appears to have peaked in 2011; overall, the Economist's commodity price index is down 15.6% year-on-year through August in dollar terms. Much of this fall in demand is attributable to slower growth in China, which -- to take just one example -- accounted for approximately 80% of new global oil demand last year. If Chinese growth slows more quickly than the government expects -- Michael Pettis of Peking University claims that Chinese GDP growth of 3-4% is more consistent with the authorities' stated goal of dis-incentivising investment and encouraging consumption spending -- this drag on commodity prices could become severe ( see INTERNATIONAL: China is key to emerging power fortunes - September 20, 2013).

Reduced remittances.

Some emerging economies, particularly Mexico and several Central American states, have started to experience reduced remittances. Emigration has fallen sharply since 2008, new emigrant flows are falling (as border controls tighten) and their expatriate populations put down roots. While the World Bank expects global remittances to rise 6.3% this year, this represents a gradual slowing of the surge seen at the end of last decade.
More resilient emerging economies.

Investors have reacted to these gathering headwinds by attempting to distinguish between:

'resilient' emerging economies (those that have arguably achieved more sustainable growth via economic diversification, improvements in governance and adherence to rule-of-law principles); and

'fragile' developing states, or those that rode the commodity price boom to strong growth without diversifying their economic output or even increasing the volumes of their commodity exports.

Many emerging economies, such as the Philippines and Mexico, may fall into the 'resilient' camp. Since the 1990s they have drastically expanded their foreign exchange reserves, applied stiffer banking and financial regulations, and made many lasting governance improvements.

Exposed emerging companies.

Yet investors may be fooling themselves by believing that long-term progress in certain developing economies makes them less prone to short-term volatility -- volatility created, in many cases, by the loose credit conditions of the past decade. Many companies in South-east Asia and parts of Africa have accumulated large foreign currency debts (see SOUTH-EAST ASIA: US Fed move rescues debtors for now - September 25, 2013). This debt is becoming more difficult to service as global credit conditions begin to tighten -- though the Fed's decision to delay QE 'tapering' until next year has bought such firms some time.

Contagion risks.

The greatest source of vulnerability, though, may be investors themselves, as they are likely to react when evidence of serious crisis in one or more of the more vulnerable developing markets begins to emerge.

'Information cascade' phenomenon.

In the midst of a crisis, there is usually an overwhelming compulsion to ignore fine distinctions and dive out of particular asset classes. This is what happened during the Asian financial crisis of 1997-98, when unrelated economies -- such as Brazil -- eventually experienced major selloffs simply because they were perceived by investors to be part of the same emerging asset class.

Behavioural economists call this phenomenon 'information cascade'. Normally, markets reflect the aggregation of all relevant pricing information; during an information cascade, market participants simply react to what other participants are doing (usually selling) and ignore all other information.

Outlook.

Certainly, there is an overwhelming case to be made that emerging markets will continue to outperform developed markets over the long-term. However, there is also a strong argument that the last decade -- which witnessed both high growth and considerable stability in much of the developing world (with a few notable exceptions, such as the Arab uprisings) -- was an aberration, not the 'new normal'. The coming decade is likely to witness much greater volatility in the developing world, and greater stability in rich economies.

CONCLUSION: After a decade of rapid, credit-fuelled growth, the most severe risks facing the global economy are now weighted heavily towards emerging markets. Investors have sought to counter concerns over growing developing-world risks by focusing on markets that they believe have achieved sustainable (eg, non-commodity price-driven) growth. However, this distinction may mean little if and when crisis conditions develop.

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