Emerging Warnings For Emerging Markets

Remember those drivers' education training films, the ones wherein each little hill in the road obscured an eighteen-wheeler barreling down upon you in your lane? The late comedian George Kirby had a solution for this uh-oh moment: As the truck driver, he would awaken his partner Earl. Why? "Because Earl has never seen a crash like this before."

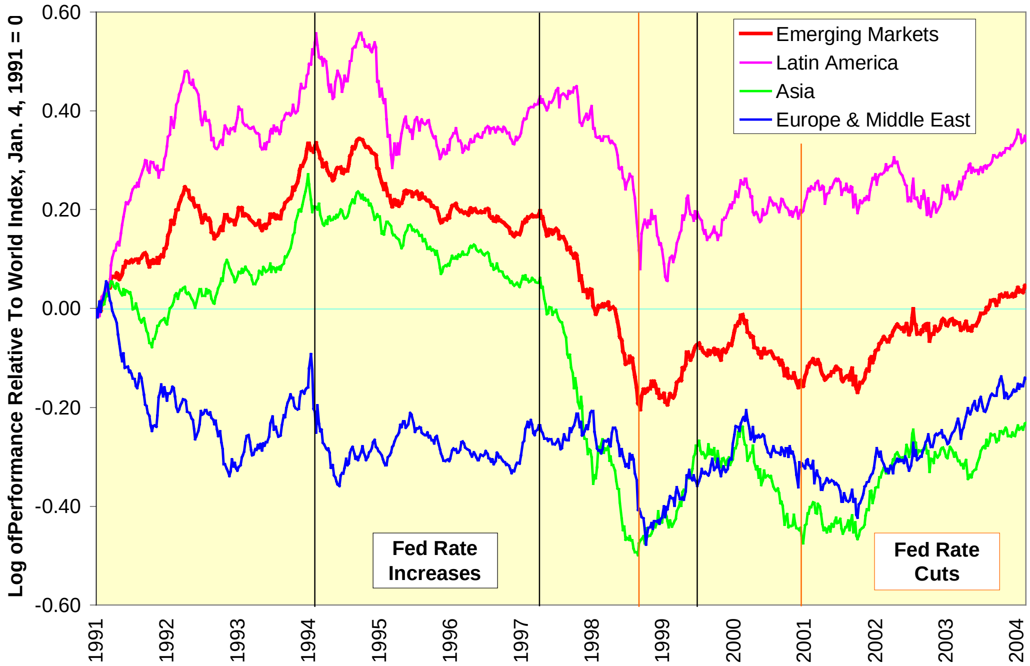
Let's put aside the obvious question about emerging markets, which is why they have not emerged fully after all these years of trying, and turn to the risks posed thereto by the potential for higher interest rates engendered by higher inflation. In fairness, emerging markets are not alone in this exposure. The list of potential victims of any forthcoming interest rate increase is a long one. In fact, it includes any investment with direct exposure to more than the short end of the Treasury yield curve; the implications of the Federal Reserve raising rates prematurely or clumsily are such that they may be deterred from taking actions until absolutely forced to do so.

Define Your Terms

The very term "emerging markets" constitutes a too-sweeping generalization, and should be used with appropriate caution. After all, the greatest emerging market of all time was the United States in the nineteenth century, and we had market panics in 1819, 1837, 1857, 1873, 1894, and early in the twentieth century, in 1907. The legacies of various investment booms, financed chiefly by the British, all still visible in many cities' canals and railroads; the Chicago & Northwestern railroad, for example, runs on the "wrong" side of the tracks by virtue of its British financiers. Whether China, presently moving lickety-split toward the front rank of world economies, will make the ascent smoothly or as roughly as we did will be one of the key questions of the next decade. No economy can function indefinitely without private property rights and sanctity of contract law. The Chinese deficiencies in this regard should give pause, as should their volume of non-performing bank loans.

The world of investment analysis has no shortage of indices, I am happy to report, and we can use the consistent methodology of the Morgan Stanley Capital International indices to decompose the broad emerging market free-float index into the regions of Latin America, Asia and Europe/Middle East. The relative performance of these indices then can be compared to the MSCI All-Country World Index.

Boom, Bust, Repeat If Necessary



A few elements stand out in the chart above. The first is the very high volatility of the Latin American markets. Their history of currency devaluations and debt defaults followed by unilateral arrangements by the United States such as Brady bonds to reschedule debt or multilateral rescues by the IMF create a strong boom-and-bust cycle. This history could be extended backwards quite a ways, and probably will exist for the indefinite future as well for reasons upon which we will dwell no further.

But even with these foibles, the MSCI Latin America index has remained a global outperformer since the start of 1991. The second feature standing out from the chart is just how quickly the Asian markets fell in relative performance from early 1994 to late 1998. The ongoing Japanese recession eliminated an important market for many countries in this region, and the Chinese growth had yet to accelerate to its recent levels.

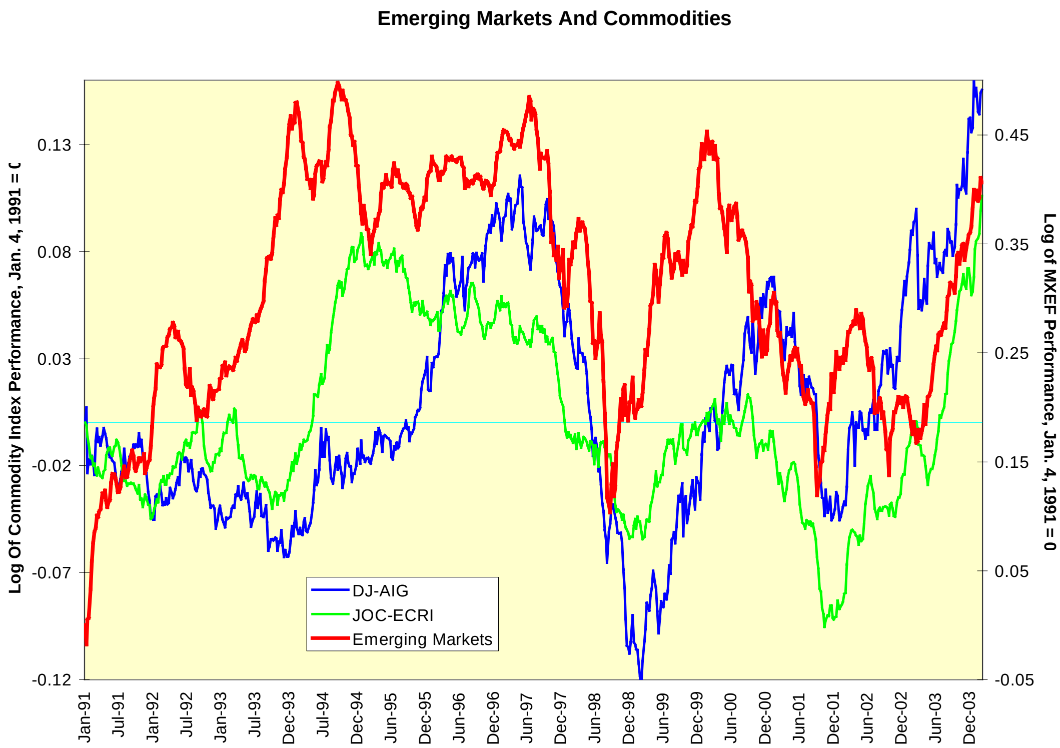
A Rifle Producing Shotgun Damage

The third and by far the most salient feature of the chart is just how sensitive relative emerging market performance is to U.S. monetary policy. The beginnings of three Federal Reserve tightening cycles, those of 1994, 1997 and 1999 all coincide with local maxima in the general emerging market index (MXEF, the basis for the EEM exchange-traded fund). The effects are symmetric. The Fed's rate cuts in the aftermath of the Russian default and Long Term Capital Management fiasco and the start of its rate cutting in January 2001 both mark local minima in the MXEF's relative performance. An accumulation of an additional 100 basis points of rate cuts in the August-October 2001 period put in what has been a lasting low in relative performance.

The widespread impact of American monetary policy has grown during the Greenspan years for reasons unrelated to Sir Alan himself. The collapse of communism and the integration of the former Soviet Union and its satellites and China into the global economy represent a triumph of the market system. But markets are efficient, which means their natural tendency to close arbitrage opportunities increases the short-term correlations between markets. If capital markets everywhere are based on LIBOR, if currencies and key commodities everywhere trade to the dollar, and if equity managers everywhere increasingly are benchmarked to common indices, then the actions of the key central bank in the system will have a disproportionate effect. The effects increase with leverage and dependence on credit spreads, all of which has been fun for emerging market investors over the past year, but will turn nasty if and when the federal funds rate starts to rise.

Commodities Matter, Too

Many emerging markets are dependent on commodity exports; this always is an unfortunate position in which to be as no one can add value to a commodity in relation to the goods manufactured therefrom. Commodity prices are cyclical in nature as both producers and consumers respond rationally to price changes. The surge in financial liquidity and a global economic recovery has pushed both exchange-traded commodities, here represented by the Dow Jones-AIG index, and industrial commodities, here represented by the Journal of Commerce-Economic Cycle Research Institute index, to multiyear highs.



The relationship between commodity prices and emerging market equities is multifaceted. The MXEF has over this period moved higher well in advance of commodity prices, while their collapses have a mutually reinforcing quality. The last two years have witnessed a simultaneous rally driven by the factors noted above, which raises the distinct possibility of a simultaneous downturn.

Nothing yet is forcing the Fed's hand to raise rates. Given the liquidity addiction of so many markets this is a good thing; they all went up at different times and different rates in response to lower rates, but the response to a tightening is likely to be far more simultaneous and dramatic. Earl, wherever he is, would want to see it.