The St. Valentine's Day Emergence

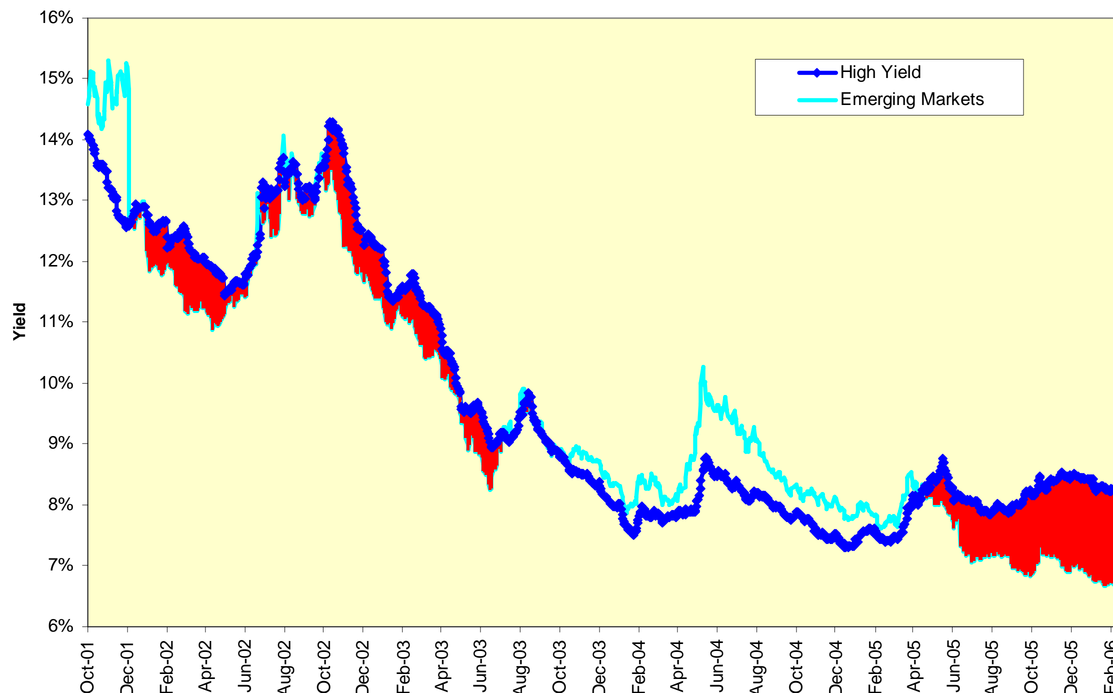
What did we call emerging markets twenty years ago? The obvious answer should raise the cynical question, "OK, why haven't these markets emerged already?" That very same question was posed here two years ago. The conclusion reached then was the impending end to 1% federal funds rates would do what higher short-term interest rates have always done to the miners' canaries of the financial world, expose their leverage. The weak and fragile, be they high-yield bonds, debt-fueled real estate operators or emerging markets financed by the hot-money operators of the world, would get their comeuppance and the rightful masters of the universe would reassert their rightful station on the throne. The dollar would strengthen as interest rates differentials moved in favor of the U.S. Oh, and tighter money would cool the commodity rally then loose upon the land.

First, They Came For The Bonds

But over the past two years, something remarkable has happened. The Federal Reserve did, as threatened, start to raise interest rates. Fourteen times in a row, in fact; while we can believe we are getting close to the end of this campaign, we still have no definitive end date. By April 2005, the more fragile corporate borrowers in the U.S., the auto industry in particular, did see their yields surge and their credit default swap insurance costs rise. The real estate party has not closed yet, but the proprietors are starting to turn the chairs upside-down on the empty tables.

So what have emerging markets done? First and foremost, their bonds' credit spreads have diverged from a longstanding link with U.S. high-yield bonds. Amazingly, since the auto industry's stumble in May 2005, emerging market credit spreads have been lower than U.S. high-yield spreads. Buy Gambia, sell GM?

Emergence And Divergence



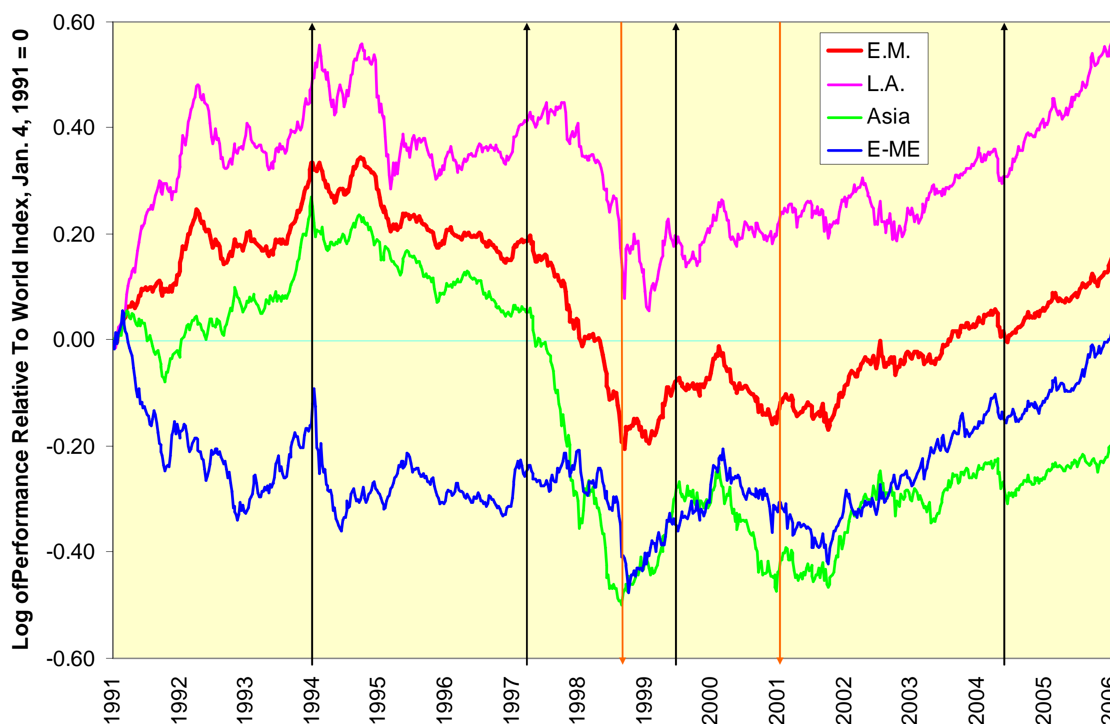
While emerging market bonds have yielded less than high-yield bonds before, as depicted in the shaded areas, these periods typically occur during general rallies for risky bonds. The current period of lower emerging market credit spreads is occurring during a sideways market for high-yield bonds. Moreover, the spread is both unusually wide and is getting wider with time.

If we are willing to accept credit spreads as a mark of respectability in the financial world – and we certainly seem to do so – we have to be willing to call emerging markets more respectable than lesser U.S. corporate credits. Ouch.

Then They Came For The Stocks
Just as we should be careful not to aggregate individual commodities into a collective entity called "commodities" without highlighting their differences, we should make the same caution with respect to emerging markets. Of course, the shoot-first, think-later crowd finds this admonition easy to ignore; just witness how many times in the past an Argentine loan default has led to a downturn in the Mexican peso as if the two countries were related by anything more than language.

But just as is the case for commodities, flows can create their own performance. There is no shortage of mutual funds devoted to the sector, and how hard is it to imagine commercial lenders deciding to extend or retract credit en masse to entire regions? Guilt by association is a fact of life in capital markets; just ask anyone who was trying to peddle a dotcom business plan in 2001.

With these cautions in mind, let's disaggregate emerging markets into three regions as defined by Morgan Stanley Capital International, Latin America, Asia and Europe-Middle East. We can compare the performances of these three indices and of the aggregated MSCI Emerging Market Free index to the MSCI World index of "developed" markets. Let's also overlay a set of upward-pointing arrows for times when the Federal Reserve began to raise rates and a set of arrows for when they began to cut rates.

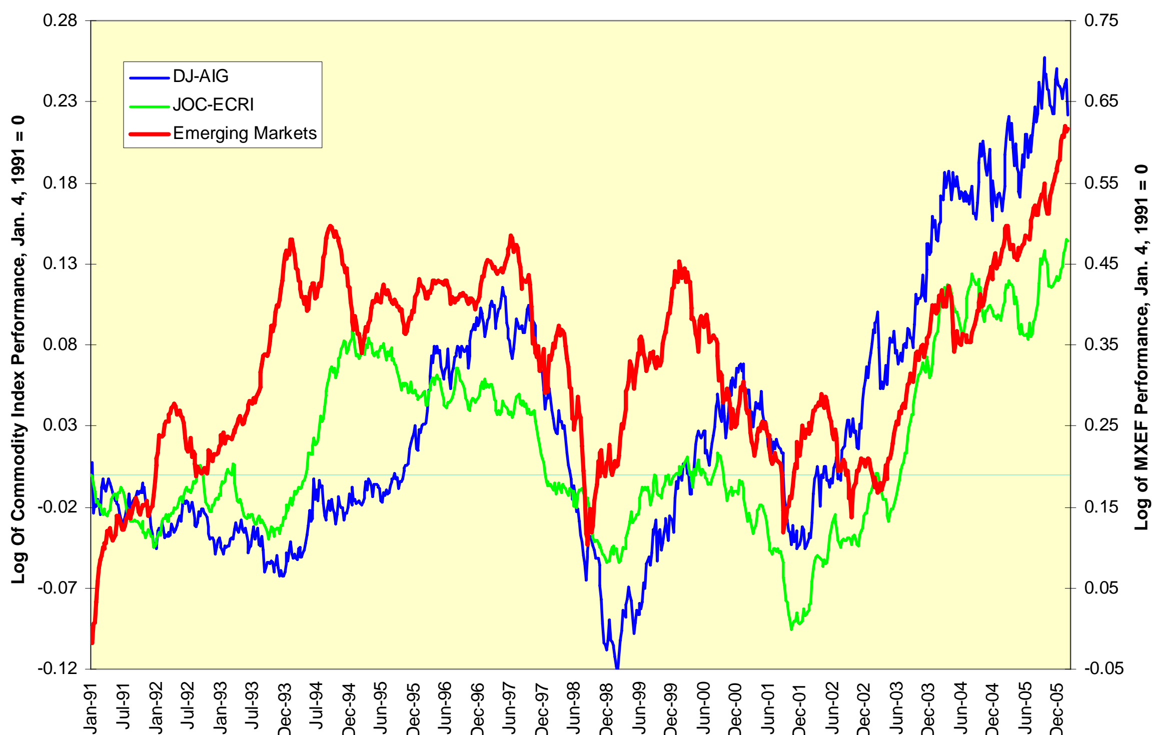


The U.S. rate hikes in 1994 and 1997 led to some notable emerging market mishaps, specifically the 1994 Mexican peso collapse and the 1997 Asian crisis. The rate cuts following the Russian default/LTCM debacle in 1998 were followed by an immediate outperformance by the various emerging markets, as were the rate cuts starting in 2001. The late 1999 rate hikes were followed by the tail end of the tech bubble and the subsequent global bear market.

What have been the consequences of the last 14 rate hikes starting in 2004? Outperformance by all the MSCI sub-indices, that's what. The Latin American and Europe-Middle East regions have advanced the most. This is a sharp divergence from previous behavior and along with the bond market spreads discussed above gives us reason to believe that emerging markets have emerged. Cheers and congratulations are in order; nothing can remain in a permanent state of emergence.

The Commodity Connection
A fair question arises whether this new world order is simply an artifact of a commodity bubble. Indeed, as the chart below illustrates, it is difficult not to see a connection between the MSCI Emerging Market Free index, the Dow

Jones-AIG commodity index and the Journal of Commerce-Economic Cycle Research Institute index of raw materials.



It is probably fair to suggest the following mechanism for this connection: The Federal Reserve's rate cuts stimulated consumption in the U.S. This demand was satisfied by low-cost producers in China. China's industrialization stimulated commodity demand and prices, and the countries on China's periphery prospered by supplying China. One of the odd aspects of the China story is how dreadful its stock market has been for outside investors; it has an average annualized loss of more than 11% over the past five years. Taiwan, Korea, India and other South and East Asian stock markets have boomed, as have the oil-fueled bourses of the Middle East and Russia.

So long as the world avoids a recession from whatever cause, including excessive monetary tightness in the U.S. and elsewhere, the China growth story can continue. Just as the U.S., which in the 19th Century was the greatest emerging market of all time and enriched its suppliers and customers with its growth, became a self-sustaining economy, and just as postwar Europe and Japan came back as self-sustaining economies, the emerging markets are at the self-sustaining point at last.