

Since the fourth quarter of 2008 the world has suffered the worst recession since World War II. The emerging economies too have not escaped sharply slowing or even negative growth. Populist theory claimed that emerging markets were decoupled from the problems of the US and other developed economies, however, as the credit crisis unfolded it became clear that investors were unlikely to find a safe haven in any market.

April 2009

insights

ING INVESTMENT MANAGEMENT

## Emerging Markets: Testing the Decoupling Theory

### The role of emerging markets has changed

In the past, emerging economies were frequently 'the place to be' temporarily for western and Japanese investors, only to be forgotten again for a while after a crisis in one of the countries or regions. Emerging markets were included in equity or bond portfolios only during time of an economic boom. In periods of economic weakness, investors withdrew their capital.

A crisis in one of the emerging economies in the eighties or nineties had a tendency to infect a whole region or even the entire emerging market universe. That was largely due to the great dependence on foreign capital.

That situation has now mostly changed. That the contagion phenomenon now plays a different role is demonstrated by the origin of the present crisis, which began in the US and spread to the global real economy via the financial economy. Countries that are highly dependent on foreign capital are vulnerable at times of global economic upheaval. But now these may just as easily be mature economies.

Emerging markets have, on balance, become more stable as a universe, but have in a short time become a much more important component of the global economy.

This new situation has a double effect. On the one hand, export-orientated emerging markets are, and will remain, considerably dependent on developments in the mature economies. On the other hand, and this is a new phenomenon, the mature economies are affected much more by economic movements in the emerging economies than they were in the past.

Therefore emerging and mature economies are much more closely intertwined than ever before.

### Does Decoupling Exist?

There is nothing like a brutal bear market to test widely held assumptions that helped to fuel the immediately preceding bull market. Arguably the biggest lesson learned over the past 18 months is that systemic risk is not some quaint concept that a future generation may need to address.

Another victim of the current malaise is the notion that emerging economies and markets are not a high beta extension of activity in the developed world, but that their long-term growth and increasing financial stability would largely insulate them from adverse developments in the US and other developed economies.

Through mid-2008, emerging markets held up relatively well in the unfolding global credit crisis. In the course of 2008's third quarter, and particularly after the collapse of Lehman and the bail-out of AIG in September 2008, emerging markets contracted viciously.

The combination of sharp commodity price declines, and a frantic global rush to reduce leverage and repatriate capital to plug domestic holes, precipitated a herd-like retreat from almost all major emerging markets, which had received disproportionately high flows in the prior years.

As Table 1 on the following page reveals, in less than five months (from the end of May through late October in 2008) the carnage was universal. Emerging markets bore the brunt of this, with individual major markets down anywhere between 45% and 70%.

The retreating elephants also forced severe devaluations of most of the emerging currencies, particularly versus the US dollar, between July and October. What began as a global credit crisis emanating from “the West,” has since effectively derailed the global economy.

Table 1: Emerging Market Decoupling: A Nuanced Tale

Country	GDP 2009 % growth (est.)	Current account to GDP (%) 2009	USD 5/31/08-10/24/08	USD 10/24/08-04/02/09	Local Index
<b>Developed</b>					
US	-2.2	-3.3	-37	-4	S&P 500
Euro Zone	-2.4	-0.8	-52	1	DJ Euro
United Kingdom	-3.1	-2.0	-48	0	FTSE 100
Japan	-5.3	2.0	-35	-2	Topix
<b>Emerging/Developing</b>					
<b>Asia</b>					
China	6.0	6.1	-45	32	Shanghai Comp.
India	5.0	-3.7	-55	18	Sensex
S. Korea	-5.9	1.2	-63	46	Kospi
Taiwan	-6.5	7.9	-49	20	TWSE
<b>Latin America</b>					
Brazil	-0.4	-2.2	-70	43	Bovespa
Mexico	-2.6	-3.4	-55	7	Bolsa
<b>Eastern Europe/Africa</b>					
Czech Republic	-2.0	-2.3	-59	-5	Prague S.E.
Hungary	-3.0	-3.7	-62	-3	Budapest S.E.
Poland	0.7	-4.9	-60	-5	WIG20
Turkey	-2.0	-3.4	-56	17	ISE Natl 100
South Africa	-0.8	-7.0	-60	42	JSE All Share

Sources: GDP/Current Account: The Economist, March 28th; Market returns: Bloomberg

Chart 1: German export growth to China versus US/EU



Sources: Bundesbank.

Last year the entire global economy had to contend with a sharp rise in metal prices owing to extreme demand from countries like China, but then it all changed rapidly once the credit crisis took hold. Contracting consumer demand in the US and Europe has hit large exporters of consumer goods especially hard, with South Korean, Taiwanese, and Japanese economies all expected to contract by more than 5% this year. Even China has wobbled, and has seen its growth rate come down from 10% to an expected 4%.

India is coming through relatively unscathed, as it is not a large industrial or consumer product exporter while its service exports remain fairly stable. Brazil is expected to have a mild recession, while Mexico, as a swing producer for the US, is faring much worse. Eastern Europe, as developed Europe’s swing/outourcing partner, has also seen its fortunes decline sharply. In South Africa the recession is projected to be mild.

That the emerging economies have become much more closely intertwined with the mature economies is also illustrated by the sharp decline in German exports. German exporters, who in the past few years have reduced their dependence on the American market in favour of the Middle East, China and other emerging economies, are now feeling the consequences of the collapse in demand from those countries.

To sum up, globalisation means that all countries are now in the same boat.

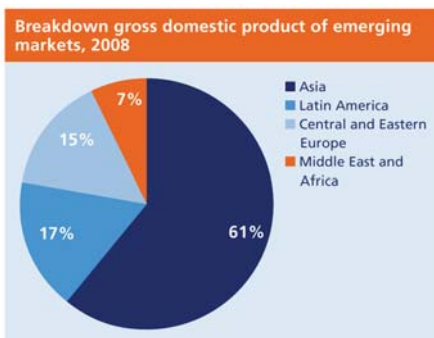
### Current State of Play

The global economic situation has deteriorated sharply in a very short time. Debt reduction by consumers and banks in the US and several European countries will depress growth for a while yet. The combination of credit crunch and severe recession in the global economy is a previously unknown phenomenon. This makes the downward risks appreciably higher than usual, both for the emerging and for the mature economies. Should the crisis lead to de-globalisation, then a slower growth rate cannot be ruled out.

Assuming 2009 is the calendar year in which the global economy is at its nadir, the expected growth for 2009 makes sober reading.

If the rejection of the decoupling thesis is fully valid, global market events since late October 2008 do not underscore this. While October/November last year was the trough for emerging markets as a whole, the major US, European, and Japanese markets fared badly after this and reached, albeit conditionally, a low in early March 2009. Despite the sharp recovery in the month of March, the developed markets are still near their levels of October last year.

Chart 2: Breakdown gross domestic product of emerging markets, 2008



Sources: ING Investment Management

With some exceptions, the emerging markets are well above these lows. Assuming the global sell-off culminated into this March low, if emerging markets are a high beta play why would they have bottomed fully six months before those in the US, Europe and Japan? The notable exceptions are the “swing” producers (Eastern Europe and Mexico) where the case for decoupling should arguably never have been made in the first place.

If investors do position their global portfolios on a no-decoupling basis, they may be at risk of leaving a good source of return on the table if the notion of decoupling is wholly or at least partially true.

### Long Term Fundamentals Still Sound

While the global economy is nowhere close to being out of the woods, recent indicators – from US housing to Chinese production – are not quite as dire as markets had been anticipating. The G-20 meeting in London appears to have concluded on a fairly constructive note.

Consumption growth in the developed world will remain constrained, however, for the time being. The prospect of demand stabilisation, the unfreezing of trade credit, and domestic demand growth in the emerging economies is a package deal on balance good for the emerging markets.

In the longer term, growth is expected to be markedly higher in the emerging economies than in the developed economies, although a lower growth rate than in previous years cannot be ruled out. Owing to considerable increases in productivity, the currencies of emerging markets may be expected to appreciate substantially against the US dollar and the Euro.

Regardless of whether you subscribe to the decoupling theory or not, emerging markets have, in our opinion, become structurally important to both equity and bond investors with a long-term horizon. They are an integral part of investment policy, including strategic asset allocation.

#### About the Author

The views expressed represent an extract from reports by ING Investment Management’s Americas and European investment specialists.

This material is for information purposes only, and does not constitute investment advice, and is not intended as an endorsement of any specific investment. Information and opinions are derived from proprietary and non-proprietary sources. Past performance is no guarantee of future results.

While reasonable care has been taken to ensure that the information contained herein is not untrue or misleading at the time of publication, ING makes no representation that it is accurate or complete.

Copyright and database rights protection exists in this report and it may not be reproduced, distributed or published by any person for any purpose without the prior express consent of ING. All rights are reserved.

**ING Investment Management Limited**  
 ABN 23 003 731 959  
 Level 21, 83 Clarence Street  
 Sydney NSW 2000 Australia

#### Disclaimer

This document contains proprietary information of ING Investment Management Limited (INGIM) ABN 23 003 731 959 AFS Licence 233793. The opinions contained in the document may not be modified or otherwise provided, in whole or in part, to any person or entity without INGIM’s prior written permission. The information in this document is provided by INGIM and is based on current information as at the date of publication. INGIM does not guarantee the repayment of capital or investment performance.