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DECEMBER 2013

WHITE PAPER

EMERGING MARKETS:

What can be learned from crises of the past

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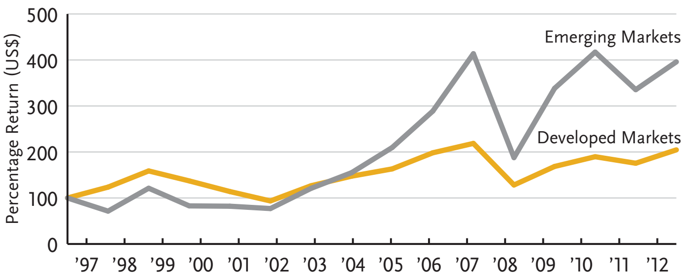
The performance of Emerging Market (EM) equities over the last two and a half years has come as a big disappointment to investors who had expected high and stable returns from the region to continue forever. Since the recent peak in April 2011, EM equities have fallen 18% in absolute terms and have given up 26% against their Developed Market (DM) peers (April 30, 2011 to September 30, 2013, U.S.-dollar terms). This has led many investors to question whether or not the region is in crisis, if there has been a structural change in EM and if they should rethink investing in the region altogether.

Certainly the outperformance of EM equities over the last 15 years has been dramatic. From 1997 to the end of 2012, EM produced a 10% Compound Annual Growth Rate (CAGR) (total return in U.S.-dollar terms) compared to 6% for DM.

Emerging Markets



Source: Thomson Reuters Datastream

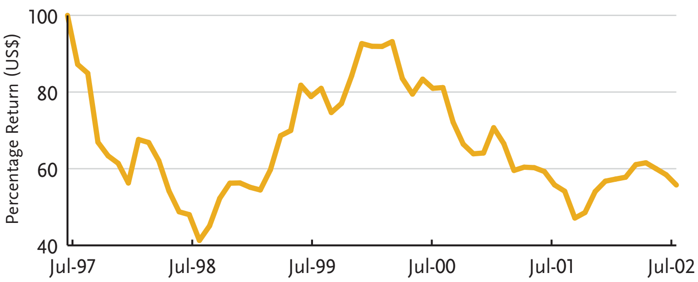
However, it is easy to forget the extreme volatility that was seen during this period. The best performing year saw the region rally 81% and the worst year saw it give up 54%. The annual standard deviation of EM over the period was at 41% compared to 23% for DM. Overall, volatility is a fact of life in Emerging Markets.

In this paper, we will look at a number of crises during this period in various EM regions and how the equity markets responded. By doing this, we will attempt to create a benchmark by which we can assess the current situation. Based on past experience, we can try to determine whether today is a repetition of the past and how we can expect the markets to respond.

Asian contagion crisis – market peak July 1997

The Asian currency crisis started in Thailand in July 1997. Many Asian currencies had been running with exchange rates fixed to the U.S. dollar. This resulted in strong capital inflows into the region with investors attracted by the high rates of return available. It also led to a sharp increase in the amount of foreign-denominated debt in the corporate sector, as investors availed of the low interest rates available elsewhere. Because of imbalances that had built up, the currency pegs became unsustainable.

Asia ex-Japan Datastream Market



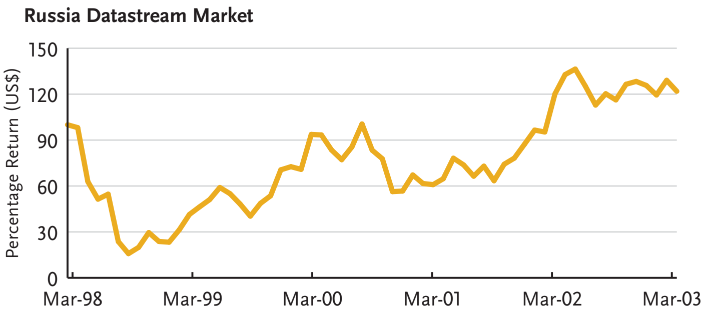
Source: Thomson Reuters Datastream

Thailand, South Korea and Indonesia were impacted the most by the crisis although economies were sharply depressed across the region. The currency collapse saw debt levels and bankruptcies soar and ultimately the financial sectors in Thailand and Indonesia needed to be rescued by the government. Indonesia's crisis is estimated to have cost over 50% of GDP, with the cost of cleaning up one public sector bank, Mandiri, estimated at about one-third of GDP. Overall, at their lows, Asia ex-Japan equities were down 60%.

Russian financial crisis – market peak March 1998

The Russian financial crisis or 'Ruble' crisis began to impact the equity market in March 1998 and at the lows saw investors give up over 80% of their investment.

In the years before the crisis, Russia had endeavoured to keep the ruble within a narrow trading range relative to the U.S. dollar, roughly 6 rubles to every U.S. dollar.



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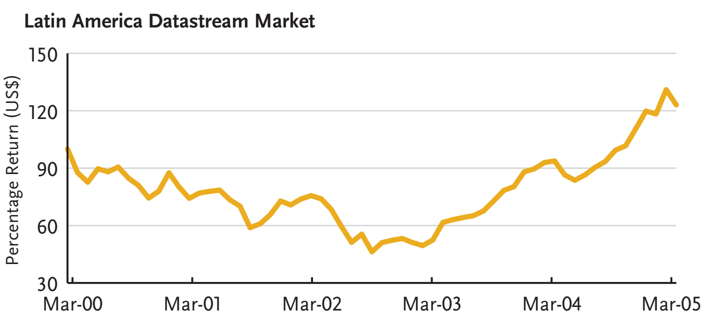
However, declining productivity, fiscal deficits, the war in Chechnya and lower demand for Russia's crude oil exports prompted capital inflows to slow dramatically, putting severe pressure on the exchange rate. While the government managed to maintain the exchange rate band until August of 1998 by depleting its foreign currency reserves, raising interest rates and receiving US$22.6B from the IMF, eventually the currency collapsed. The currency fell to 20 rubles to a U.S. dollar by the end of 1998. As a result, Russia was forced to default on its debt.

Latin American crisis – market peak March 2000

Many parts of the Latin American region suffered from a financial crisis at some stage during the 1980s and 1990s. The origins of these crises stemmed from the large levels of capital, predominantly oil revenues, which flowed into the region in the 1970s and 1980s. The subsequent outflow of capital put severe strain on the economies of most countries in the region. This followed the announcement by the Mexican government that it would no longer be able to service the large amount of debt that it had accumulated. In the early part of the 2000s, Argentina and Brazil came to the fore.



Source: Thomson Reuters Datastream

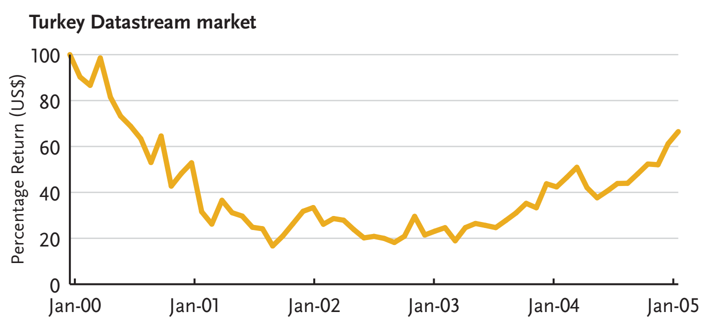
In an effort to control high deficit and debt levels, the Argentinian government decided to fix its exchange rate to the U.S. dollar. In 1999, Brazil devalued its currency as the market became concerned about the country's ability to finance its fiscal deficits and the depletion of its foreign currency reserves. This event put Argentina at a big disadvantage against its largest trading partner. Argentina's excessive domestic and international debt and high interest rates resulted in a full-blown crisis and the country ultimately defaulted on its debt.

During this same period, Brazil, the largest economy in Latin America, came under severe currency and debt pressures. Brazil was not helped by the fact that from 1995 to 2002, its national debt had increased substantially. When interest rates were increased to defend the currency, the economy became severely constrained. Ultimately, however, Brazil managed to avoid a debt default.

Latin American equities eventually bottomed in September of 2002, following a sell-off that lasted over two years and saw investors give up over 50% of their investment.

Turkish currency crisis – market peak January 2001

In an attempt to control the high levels of inflation and government deficits that had impacted Turkey for much of the 1990s, the government implemented a 'fiscal adjustment program.' This led to a severe economic and political crisis in 2000. The three-year 'disinflation plan' was targeted to reduce Turkey's inflation rate to 25%, from the rates as high as 60% that it had experienced over previous years. This involved a combination of fiscal adjustment, (i.e. reduced government spending) and structural reform in areas such as pension, agriculture and tax policy.



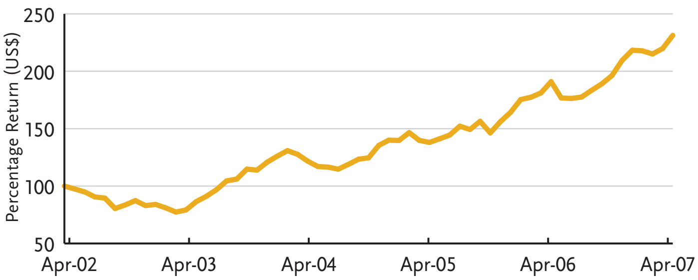
Source: Thomson Reuters Datastream

The plan was initially well received and capital flows continued into the country. However, with the Central Bank unable to 'sterilize' this liquidity (an agreed part of the plan supported by the IMF), interest rates fell and speculation increased. Doubts began to set in when the current account balance deteriorated, the reform program promised by the government failed to materialize and capital eventually began to flow out of the country. When fears for the viability of the banking sector took hold, these outflows turned into a deluge. From its highs, the equity market in Turkey gave up 80% of its value, bottoming in October 2001.

SARS crisis – market peak April 2002

In April 2002, the Severe Acute Respiratory Syndrome (SARS), or 'Avian Flu,' crisis spread across the Asian region. SARS originated in Southern China and within weeks spread across Asia and the globe. With a fatality rate in excess of 9%, the fear factor rapidly impacted economies across the region, through reduced retail spending and travel. To this day, more than a decade after the outbreak, 'fever scanners' are still in place in Hong Kong to protect against further outbreaks. The SARS crisis was a reasonably mild one by EM standards, with Asian markets off almost 30% from their highs. This is probably explained by the fact that this crisis happened shortly after the Asian currency crisis and thus markets were starting from 'lower' highs.

Asia ex-Japan Datastream Market



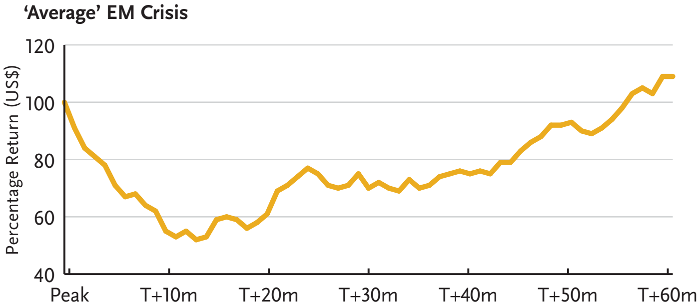
Source: Thomson Reuters Datastream

What does the 'average' crisis look like?

As can be seen from the commentary above, though there are many similarities, each crisis is different, both in terms of causes and equity market impact. Yet, using the equity market performances during and following the aforementioned five crises, the performance of an 'average' crisis can be created. This is shown on the chart below.

The starting point is the peak of the market and the equity market performance is shown for the following five years in U.S.-dollar terms.

'Average' EM Crisis



Source: Thomson Reuters Datastream

As can be seen, markets tend to go through a number of stages. As the crisis hits, there is an initial panic and investors rush to the exit, the so-called 'flight to quality.' Over the first 12 months from the peak of the market, investors could expect to lose upwards of 50% of their investment, both through equity market losses and currency depreciation.

After the initial sell-off, some rationality returns to the market. Though the situation still remains serious, valuations become so attractive that some investors begin to 'bottom fish' for opportunities. Over the next 12 months, markets rally by upwards of 40%, regaining about half of the initial losses.

While all this is going on, policy-makers and companies are making the necessary adjustments to fix the imbalances that led to the crisis. A heavily depreciated currency helps to support the export sector, aiding the economic recovery. Sometimes outside help is required, e.g., in the form of the IMF. During this period, again around 12 months, a sideways trading pattern is typical as the market remains largely off the radar screen.

At the end of this trading pattern, the benefits of the restructuring begin to feed through to the economy and the equity market moves sharply higher over the following two-year period. Bear in mind that not all of the problems need to be fixed at this stage as the equity market will generally take a forward-looking view of economic and profit growth.

Where do we stand today?

Based on history, Emerging Markets today are largely in a strong position. According to the IMF, economic growth in EM is expected to be 4.5% in 2013 and 5.1% in 2014, and growth is expected to be reasonable across all of the major EM regions. A recovery in the economic performance of Developed Markets over the same period will provide a strong tailwind. A silver lining coming out of the economic weakness in 2012 is that the outlook for inflation is also more positive, falling from a high of 7.1% in 2011 to an expected level of 5.7% in 2014.

GDP Growth	2011	2012	2013F*	2014F*
World Output	3.9%	3.2%	2.9%	3.6%
Advanced Economies	1.7%	1.5%	1.2%	2.0%
Emerging Markets	6.2%	4.9%	4.5%	5.1%
Central & East Europe	5.4%	1.4%	2.3%	2.7%
Developing Asia	7.8%	6.4%	6.3%	6.5%
Latin America	4.6%	2.9%	2.7%	3.1%
South Africa	3.5%	2.5%	2.0%	2.9%

Consumer Prices	2011	2012	2013F*	2014F*
Advanced Economies	2.7%	2.0%	1.4%	1.8%
Emerging Markets	7.1%	6.1%	6.2%	5.7%

Source: IMF, October 2013
*Forecast

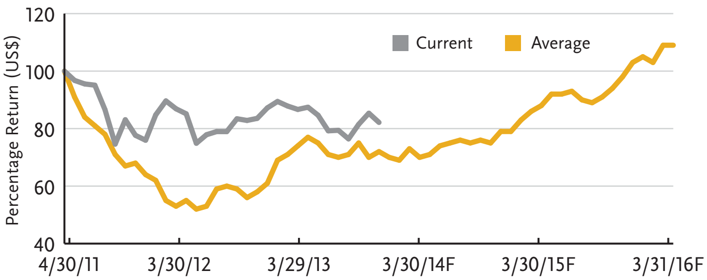
EM equity market performance peaked in April 2011 and has underperformed substantially since then, suggesting that the region is in some form of crisis.

Over the 12-month period from the peak, EM fell by just over 20%. This is not as severe as the average crisis, which seems logical as the imbalances are not as large as they have been in previous crises (e.g., fixed exchange rates are less of an issue and debt levels are more manageable).

Given that the initial sell-off was not as severe, the following recovery was not as strong and the market appears to have entered the trading range pattern, largely in line with where it should be. Based on past crises, we believe this should last until April 2014.

At this stage, the region will have had three years to address its issues and the low valuations and improving fundamentals should begin to see the market trend higher.

Crises Comparisons



Source: Datastream, August 30, 2013, price return in US$. SARS – April 2002, Russia – March 1998, Latin America – March 2000, Turkey – January 2000, EE – December 2007, Asia – July 1997.

Lesson to be learned

As a result of the current 'crisis,' valuations are providing a good entry point into the asset class and the upside potential is significant. The price-to-earnings ratio of EM equities is 12.4×, compared to 16.7× for Developed Market equities (Datastream Indexes, September 30, 2013). Yet, a lot of hard work still needs to be done. For those EM countries with large current account deficits, capital flows need to be sustained. The weaker currencies resulting from the recent sell-off will help to increase exports and decrease imports, improving deficits. However, strong reform programs need to be implemented to make their economies more attractive to foreign capital. EM countries have responded well to the crises of the past and will likely continue to do so in the future with equity markets responding favourably as a result.

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Published Date: December 18, 2013

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