

The world turns – from emerging to developing markets

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Key points

- > The world is turning. While the US, Japan and Europe are starting to look brighter the emerging world led by China, India, Brazil & Russia is looking a bit less bright.
- > This is seeing the long term secular cycle in investment markets move in favour of traditional global shares relative to emerging markets and Australian shares, and will work against commodities and currencies like the \$A.

Introduction

Based on medium term economic growth potential, emerging market shares should be a slam dunk to outperform developed market shares. But of course it is never that simple. This certainly panned out last decade with emerging market (EM) shares – dominated by Brazil, Russia, India and China – dramatically outperforming developed market (DM) shares – dominated by the US, Europe and Japan. But it certainly hasn't been panning out that way this year with EM shares down year to date against double digit gains for DM shares. In fact, this underperformance is evident over the last few years now.

With the US, Europe and Japan rebuilding after a horrible decade (or two in the case of Japan) and key emerging market countries looking a bit less bright, this change is likely foreshadowing a longer term secular swing. This has big implications for commodity prices, commodity currencies like the \$A and for Australia generally. But first a bit of historical context may be of use.

The last decade: great for EMs, commodities & Australia

The last decade or so saw core developed countries struggle. Japan hit the wall in the 1990s, but the tech wreck brought Europe and the US undone from 2000 and then they were hit by the global financial crisis and subsequent periodic public debt scares.

By contrast, emerging countries recovered from the Asian/EM crisis of 1997-98 benefitting particularly from the economic reforms (privatisation & deregulation) that followed and were then given a huge boost as China rapidly industrialised averaging economic growth of more than 10% pa. This all occurred at a time when the supply of industrial commodities was constrained by years of underinvestment by resources companies, which in turn reinforced the boom in the emerging world given the commodity exposure of South America and Russia. The net result was:

- A significant underperformance of developed market shares relative to emerging market shares, starting with the end of the emerging market crisis in 1998, but really accelerated following the start of the tech wreck. See the next chart.

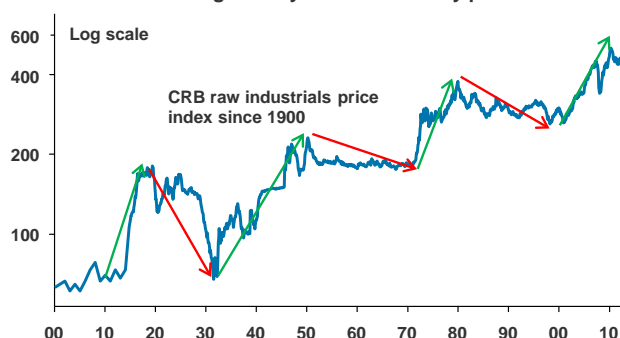
The relative performance of Developed Market versus Emerging Market shares



Source: Bloomberg, AMP Capital

- The commodity super cycle which got underway around the year 2000, on the back of strong demand from industrialising emerging countries led by China and constrained supply. See the next chart, which also puts the commodity super cycle of the last decade into a very long term context.

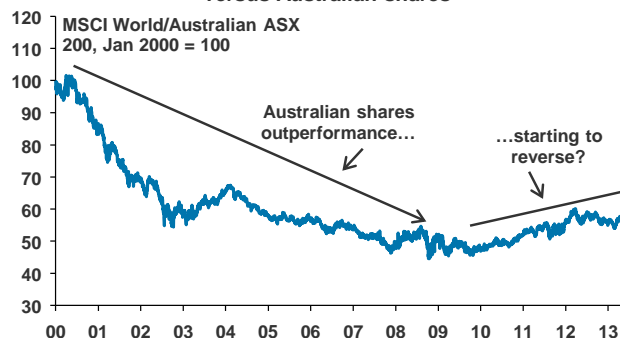
The long term cycle in commodity prices



Source: Global Financial Data, Bloomberg, AMP Capital

- Strong gains in commodity suppliers, both resources stocks and countries like Australia. The underperformance of global shares relative to Australian shares from 2000 can be seen in the chart below.

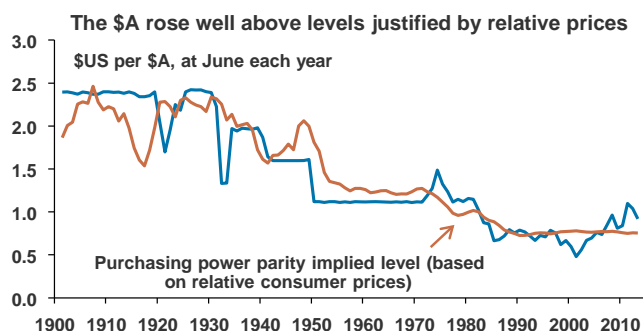
The relative performance of global shares versus Australian shares



Source: Bloomberg, AMP Capital

Note that the previous chart relates to the local currency value of global shares relative to Australian shares. The underperformance of global shares was even more pronounced if measured in Australian dollar terms.

- Strong gains in commodity currencies like the Australian, NZ and Canadian dollars, pushing them well above levels justified by long term relative costs and prices.



Source: RBA, ABS, AMP Capital

However, all cycles eventually come to an end. This applies just as much to shorter term (3-5 year) business cycles as it does to longer term (decade plus) secular cycles referred to here. This partly occurs as the forces which drove the cycle are pushed to an extreme setting the scene for a reversal.

Changing world...

And this appears to be what is happening at the moment. Several factors are now driving a reversal in the longer term secular cycle of developed country shares relative to emerging market shares and related trades.

First, and foremost, the developed world is looking better:

- The US economy appears to be gradually mending with the housing sector recovering, shale oil and gas driving an energy boom, manufacturing appearing to enjoy a renaissance, private sector deleveraging well advanced and even the budget deficit falling to less than half its crisis levels. This has already helped the US share market break out of a 13 year secular bear market.
- Japan finally seems to be awakening after a 20 year slump with the Bank of Japan committing to end deflation and the Government aggressively targeting stronger growth under Abenomics.
- The Eurozone appears to be gradually emerging from a crisis over its existence with peripheral countries adopting economic reforms that will likely enhance long term growth potential.

Second, this is occurring at a time when the emerging world is looking a bit less bright:

- While the Chinese authorities reportedly see 7% growth as the bottom line for acceptable growth, this is well down from the 10% plus growth of the last decade. What's more the risks around the Chinese economy appear to have increased after several years of rapid debt growth.
- India, Brazil and Indonesia appear to be facing a less attractive growth/inflation trade-off after their economic reform agendas have faded and in some cases reversed.
- South America and Russia are vulnerable to the less favourable outlook for commodity prices.

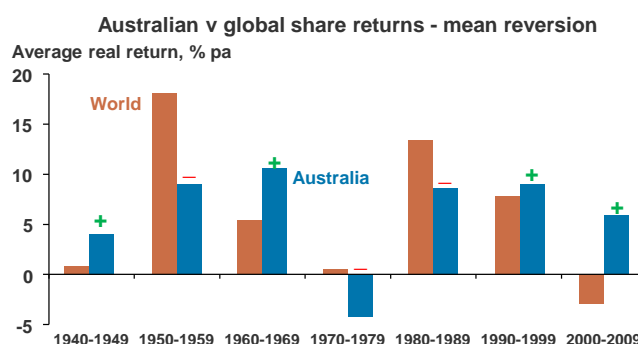
Third, many of the longer term cycles referred to above were pushed to extremes, which has elicited countervailing forces:

- The boom in commodity prices has led to a surge in the supply of commodities as resource investment spiked;
- The surge in commodity currencies has undermined the competitiveness of commodity producing countries like Australia; and
- This has occurred when the long term fall in the \$US from 2002 is contributing to the renaissance in the US;

...leading to a reversal of long term trends

The end result is that the secular trends of the last decade appear to be reversing:

- Developed market shares appear to have bottomed versus emerging market shares. See the first chart on page 1.
- Commodity prices appear to have peaked under the influence of slowing Chinese growth & increasing supply.
- The relative outperformance of the Australian share market relative to global shares looks to be reversing. See the third chart on page 1. This is not particularly unusual in an historical context. As can be seen in the chart below, mean reversion often sees a decade or two of outperformance in Australian shares (indicated by a "+") followed by periods of underperformance (indicated by a "-"). After a very strong decade of outperformance a period of underperformance may have commenced.



Source: E.Dimson, P.Marsh & M.Staunton, Global Investment Returns Yearbook 2003, London Business School/ABN AMRO, MSCI, AMP Capital

- The Australian dollar appears to be headed lower following the lead from falling commodity prices, with such an adjustment necessary if Australia is to rebalance away from reliance on now slowing mining investment.

What does this mean for investors?

There are several implications from all this for investors.

The first thing to note is that there is no reason to be alarmed. The shift in secular patterns just reflects the normal ebb and flow of investment markets. We have seen a variant of it all before.

Second, while developed market equities were to be avoided over the last decade relative to emerging market shares, they are looking relatively more attractive going forward.

Third, while the emerging world still offers growth prospects there is a case to be more selective. In particular commodity users such as the Asian region generally are more attractive than commodity suppliers such South America and Russia.

Fourth, the time for a large exposure to commodities has passed.

Fifth, for Australian investors while the high franked dividend yield offered by Australian shares is attractive there is a case for a greater exposure to global shares.

Finally, while hedging international shares back to Australian dollars made sense over the last decade when the \$A surged it will probably pay to be unhedged over the decade ahead.

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