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Emerging markets are the only growth story in town, says hedge fund Peak Partners

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"The BRIC thesis has been hashed to death," said Nikhil Jhangiani, chief investment officer at Geneva-based fund manager Peak Partners during a presentation on investing in emerging markets yesterday. "Non-BRIC emerging markets (EMs) are the only growth story in town." In fact, his basic hypothesis is that EMs are likely to stay that way for many years to come.

According to Peak Partners, the developed world is struggling with the crisis and can no longer be the driving force behind the global economy in the 21st century; leaving room for EMs to be the main growth engines of the world.

The Next Eleven (or N-11) are eleven countries – Bangladesh, Egypt, Indonesia, Iran, Mexico, Nigeria, Pakistan, Philippines, South Korea, Turkey and Vietnam – identified by Goldman Sachs as having a high potential of becoming the world's largest economies this century, along with BRIC (Brazil, Russia, India, China). However, they remain highly volatile. So portfolio managers need to be able to anticipate changes and manage them properly.

Advanced economies, it is well known, are debt-ridden and are struggling to pay back. And current budget reductions are likely to reduce their growth too.

"You cannot be the driver of anything if you are a debtor," noted Nikhil Jhangiani. "Investors need to focus on true growth and tangible assets." That is EMs, which debt ratios and fiscal deficits are less than half that of developed countries; EMs' average debt to GDP is 33% and developed countries' debt levels are expected to peak at 104% of GDP in 2013, said J.P. Morgan Securities LLC in October 2010 (Source). The firm also claims EMs passed their most important stress test in 2008-09 and are now the key drivers for global growth. Their potential growth rate is 5.8% - compared to 1.6% for developed economies. And they are expected to account for 50% of global GDP by 2017.

J.P. Morgan (according to Peak's presentation) lists six structural shifts that have solidified the growing position of EM economies, namely:

1. EMs can now implement countercyclical policies, and have been running a current account surplus of 3% of GDP on average in the last three years.

2. Many countries have moved to net external creditor status, and the average debt to GDP for EM countries has remained stable at 33.4% of GDP (in 2007, it was 32.7%). The fiscal balance went from 0.3% of GDP surplus in 2007 to 2.8% deficit in 2010. "This is very important when you need to control your own destiny," Jhangiani commented.
3. EMs' share in the global economy went from 20% to 33% from 2000 to 2010 (best on PPP, from 37% to 47%).
4. Many have had massive terms of trade gains from higher commodity prices, and EMs now account for 54% of global oil demand (44% 10 years ago).
5. EM consumption (34% of world's) now exceeds U.S. consumption (23%).
6. EMs' FX reserves ($5.6tn) have increased eight-fold over the past decade and are now nearly double the level of foreign exchange reserves of advanced economies ($3.2tn). China has 30%.

"These are all undisputed facts and watershed events," Nikhil Jhangiani said.

Who wants to put money in EMs?
His position on EMs is supported by many managers. For example, a panel at the recent CFA Institute Annual conference defended the case that EMs are underrepresented in global investors' portfolios (Source). In it, Jerome Booth, head of research at Ashmore Group plc, said that if 50% of economic activity (in terms of purchasing power parity) takes place in emerging markets, then 50% of portfolios should also be allocated to emerging markets. Current allocations are, however, much lower, and Booth attributes this to the behavioral problem of "herding" in asset management.

Derek A. Sasveld, senior investment strategist at Strategic Investment Group, cautioned that a portfolio's exposure to emerging economies may be more than its allocation because companies from emerging economies list internationally, among other factors.

Apparently there is great reticence to invest in EMs coming from the continental Europeans (but the Swiss and Anglo-Saxons are willing to invest.) Jhangiani said this comes from the non-normality and synchronicity in returns. However "EM returns are massively positively skewed." There is also the problem of governance, although "the developed world's governance is also questionable," he said. Other issues are currency, distance, etc.

In conclusion, "returns are inclusively converging with the developed world's but a broadly diversified portfolio of EMs still provides profit due to their higher returns and lower correlations."

Peak Partners' Granite Emerging Market Fund of Funds was up 2.75% (est.) in April, and 2.67%% YTD – compared to the MSCI EM 2011 with 2.83% and 4.57% YTD. The fund's annualised return since Jan-2008 (including pro-rata) is 12.70% -- compared to -2.83% for the MSCI EM index and -2.63% for the HFRX Global HF index.

The fund was covered in a recent article:
Opalesque Exclusive: Peak Partners to launch hybrid emerging markets FoFs next month
http://www.opalesque.com/62258/Peak_Partners_to_launch_hybrid_emerging_markets258.html