FINANCIAL TIMES
Last updated: February 7, 2012 7:32 pm

Avoiding EM economies is the biggest gamble of all

By Jerome Booth

Volatility looks likely to continue across equity markets in 2012. But the risks we typically care about most are large permanent losses, not volatility. There is a strong case that we do not face a plethora of potential large permanent losses from multi-country investing in emerging markets in 2012. We do from investing in the developed world.

The world this year will continue to be divided into deleveraging developed economies and emerging market economies without excessive debt. The US and Europe will continue to experience sub-trend growth, with the main risk still a return to recession or depression. Many emerging economies will grow close to trend, the main risks being country specific, not least inflation. Developed and emerging economies will continue to experience broadly synchronised intra-year inventory cycles due to the increasingly globalised nature of the manufacturing supply chain, but the underlying growth stories and the demand side conditions will continue to differ markedly.

Emerging countries are highly heterogeneous and no longer share the common feature of potential default should they be cut off from foreign capital for the simple reason that they are now often the net creditors. All their main risk scenarios are either country specific, or emanate from the mess in the developed world. The former can be avoided by a portfolio investor, the latter scenarios all pose greater risks for those invested in the developed than in the emerging world.

Markets, though, are mainly driven by risk perception, not risk directly. Markets are likely to see more confusion in 2012 as previously stable mental constructs and views are found lacking, and then gradually replaced. Shifts in perception can be radical for the individual, yet the overall cumulative effect is gradual. Greatest actual risk – that is, the risk of not being repaid on an invested amount – is in those asset classes where a triple cocktail exists: a homogenous investor base; a large underperception of risk, which is likely to reverse; and leverage. All the main candidates are in the developed world.

Until a year ago there was little inflation in the emerging markets, hence no urgent need to appreciate currencies. There followed a period of central bank inertia as uncertainty in Europe trumped the desire to diversify from the dollar. At the end of 2011, inflation pressure has again subsided. In 2012, we expect the drift in events in Europe to lead to a more definitive resumption of confidence, or crisis followed by recovery. This should lead in due course to dollar weakness (including probably but not necessarily against the euro). A sudden yen appreciation, an announcement by a big central bank of substantial dollar holding reduction, or an oil price shock could precipitate more acute dollar weakness. Most likely, though, is a more gradual diversification and reduction of emerging market central bank reserves.

The most likely path for unwinding global imbalances over the medium term is through appreciation of emerging market currencies. We expect this process to be only temporarily interrupted by bouts of risk aversion. Over the medium term, as their currencies appreciate, emerging economies will gradually come to rely more on domestic demand. In order for this shift to be non-inflationary, there will be a greater focus on addressing supply-side constraints, particularly through reforms, the development of corporate bond markets, and big pushes into infrastructure investment.

Protracted weakness in developed world demand will also spur south-south investment and trade. Countries will make further efforts to shift trade patterns more to emerging markets. Emerging market banks will take more market share from developed market peers, possibly including through acquisitions. Policymakers may take the initiative in persuading more companies to invoice in non-dollar currencies. We could also see further diversification into emerging assets by emerging central banks.

Not investing significantly in emerging markets is a form of gambling. Yet denial of this reality is strong: people believe what they want to believe. The argument for hanging on to outdated and simplistic concepts of risk and to prejudices about emerging markets is driven by hope more than rationality. We fear to question our assumptions too closely. The gambler on a losing streak may shut off reality to feed the addiction.

How long should we stay at the roulette wheel when we know our returns are likely to be low even if we don't lose everything? Do we think the status quo can last indefinitely and that the odds will continue to be rigged? Or do we just think we are lucky? Arguably, the more prudent are investing in emerging market asset classes to reduce risk – in cash markets, sovereign debt,

corporate debt and, of course, equities for those with more of a stomach for short-term volatility.

Jerome Booth is head of research at Ashmore Investment Management