AIG Global Investment Group®

Structural vs. Cyclical–What's Really Happening in Emerging Markets

by Deborah A. Vélez

May 2005

In February 2005, the most commonly used benchmark index for Emerging Market equities, the Morgan Stanley Capital International Emerging Markets Free (MSCI EM Free), broke its previous high set over a decade ago in 1994. Investors who were caught up in the euphoria over rapidly growing economies and positive demographic trends and who invested at the former peak of emerging markets have just now been made whole. The question, then, begs to be asked—is it the same all over again, i.e., are we at a cyclical peak or has there been a structural change in the market?

Emerging markets are hard to examine in aggregate, as the individual countries that make up this universe are so heterogeneous. However, if you compare the countries today to ten years ago, you will find autonomous central banks enacting monetary policies independent of government influence. Today, many emerging markets, although not all, have floating exchange rates which can bear the brunt of changes in the terms of trade. In aggregate, the Emerging Market countries have current account surpluses rather than deficits, and where balance of payments imbalances exist, they are driven more by capital goods imports than consumer goods. Across all the principal regions of emerging markets, if we weight the countries by market capitalization, the current account/GDP ratio for 2004 was positive. Many have better fiscal positions than that of the United States. The international rating agencies have recognized these changes, and today 75% of emerging market countries have received an investment grade rating by Standard & Poor's, whereas in 1994 only 46% of emerging markets countries were rated investment grade by this agency.

On the political front, an important one for many of these countries, the world has witnessed amazing transformations and a deepening of institutional capacities. In Thailand, for example, the current president is the first sitting president since the constitution to serve a full term. In Mexico, the world witnessed a peaceful transformation to an opposition party president, this from the party that had ruled Mexico since the Mexican Revolution. In Turkey, not only did a religious party win the elections, but they also won a clear majority, enabling them to avoid a coalition government which has proven fractious to policy making in the past.

This is not to say there is not a cyclical component to emerging markets. There are numerous countries where we still witness export dependency on a single commodity or low value-added in the technology outsourcing field. Corruption and political horse-trading remain issues in many places, as does corporate transparency. However, one cannot expect to gain greater return without taking on additional risk, and that risk in emerging markets is different today than it was a decade ago. Global monetary tightening does not presage a crisis in emerging markets much as structural deepening will not prevent setbacks in the market. Yes, there is cyclicality in emerging markets, but there are also permanent and positive structural changes which will continue to support the capital markets in many of these countries.

DEBORAH A. VÉLEZ, CFA is Managing Director, Global and Emerging Market Equities, AIG Global Investment Group, New York

Ms. Vélez joined AIG Global Investment Group in 1997, and the Global Equity Team in 1999. As Managing Director, she is responsible for all emerging market equity investment activities. From 1997 to 1999, she was an Investment Analyst managing AIGGIG's on-shore insurance assets in Central America, Mexico, and the Caribbean. Prior to joining AIGGIG, she was an Analyst with Baring Asset Management, an Associate with Cambridge Associates and a Senior Analyst at TD Bank. Ms. Vélez received an AB (honors) in American History from Harvard University in 1990. In addition, she received an MA in International Economics and Latin American Studies from John Hopkins SAIS, and an MBA in Finance from Wharton University. She is a CFA charterholder.