

Emerging economies able to withstand US slowdown

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The most likely outcome of any US recession is a "soft decoupling" in which the rest of the world slows a bit but avoids a recession or sharp decline in growth.

Consequently, we believe emerging market equities can continue to outperform those in developed markets, although the pace of their advance will likely moderate.

The fundamentals of many emerging markets are much stronger than indicated by their equity valuations.

If we look at the underlying dynamics, two of three drivers of emerging market growth are intact: high domestic demand and the drive to bring infrastructure up to western standards. Granted, exports - the third driver - are being damped by the slowdown in the developed economies.

To be sure, a clean and clear economic decoupling remains something of a fantasy given the pervasive forces of globalisation. But because of their much stronger fiscal standing, ballooning foreign reserves, growing revenues from the record global demand for natural resources and the rapid growth of their domestic markets, many emerging market economies are in their best shape in years and less linked to the US economy. They learned lessons from their own crises in the 1990s and 2001-2002.

It should be noted that among emerging markets, insulation from a US economic downturn varies widely and depends on relative reliance on exports to the US. But even a nation as closely tied to the US economy as Mexico is in a much better position to withstand a US slowdown because of the growth in its domestic market and the greater diversification of its exports.

China - given the sheer scale of its exports, its growing intraregional trade with other emerging nations and its surging domestic consumption - is the linchpin in the developing world's resistance to a US economic slide. Last year, for the first time, China edged out the US as the top contributor to world growth, and it has also overtaken the US as the top importer of emerging market exports.

So far, the slowdown in Chinese economic growth in response to the US downturn has been somewhat muted, and many analysts believe that will remain the case. While the International Monetary Fund expects US growth to drop by half from 2006 through this year, it predicts growth in China's gross domestic product over the same two years to fall from 11.1 per cent to a still robust 9 per cent.

But the emerging market story is a lot bigger than China. Emerging market nations hold three-quarters of the world's foreign reserves, and they are increasingly investing in long-term infrastructure programmes, for which spending estimates over the next decade top \$20,000bn.

Our preference is for business models that benefit from the emerging market durable growth cycle and are much less exposed to the cyclical global downturn. Thus our emerging market portfolios favour infrastructure plays, banks, financial services and real estate firms.

In all of this, of course, there are grey areas. Even proponents of "soft decoupling" acknowledge its limits have not been tested over time. Moreover, a good share of the growing intraregional trade within Asia - theoretic evidence

of decoupling - is simply unfinished goods bound for America. And in past US recessions, the IMF found that for every percentage point drop in US GDP growth, Asia's GDP growth fell by 0.28 per cent.

But even if that past relationship holds, investors should keep in mind the overriding forces of developmental economics. Whether emerging economies decouple from the US in the current cycle is merely a sideshow if you look beyond the next 12 months.

For long-term investors, the real emerging market growth story is much more elemental in terms of deepening capital and more productive labour deployment. Millions of people are moving from subsistence farming to urban manufacturing, resulting in a massive boost to output.

It's like a new country joining the world economy every year.

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