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CRISIL Insights

Through the CRISIL Insight Finance & Markets series, we discuss and analyse trends in the global markets. In the first issue, we focus on how the revival in emerging economies, coupled with the continuing uncertainty in developed nations, will lead to higher capital inflows to Emerging Markets.

Emerging Markets will see robust inflows in 2013

There has been a strong revival in capital flows into the Emerging Markets (EM). This surge has been triggered by two factors: the comparatively better macroeconomic situation in EM and the prospects of poor returns in advanced economies which are currently operating with very loose monetary policy. In fact, growth in EM economies has consistently outpaced developed markets over the last decade and a half as they include the fastest-growing economies and represent about 70% of the world's population. Most of these countries are going through mass industrialisation and urbanisation, and also seeing a huge boost in consumption. Their attraction for investors has been further enhanced by government and fiscal reforms which have provided further stability to the asset class as a whole.

Against this backdrop of solid long-term growth, many market participants are recommending an overweight position on EM equity and debt, given their superior return, better yield, higher credit quality and enhanced liquidity. While corporate bonds and local currency sovereign bonds could attract higher flows, broad EM-based equity Exchange-Traded Funds will continue to be preferred over country or sector-specific funds.

The Insight gives an overview of this multi-trillion dollar opportunity, and also takes a closer look at the factors that are fueling this long-term investment opportunity in Emerging Markets.

In 2007, AAA-rated economies accounted for 50% of the GDP in developed markets. Today, this number has fallen by more than half to 20%

In September 2012, the EM corporate bonds segment crossed the $1 trillion mark

Investors find Emerging Markets attractive

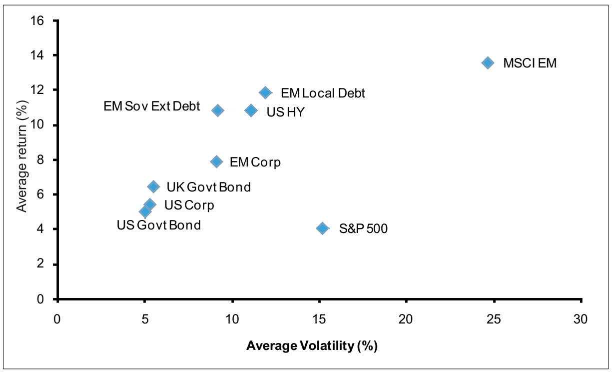
The Emerging Markets' (EM) share of global investments is much less than what it should be; this, despite the fact that EM has been delivering one of the highest risk-adjusted returns over the last decade. There is enough data available to support this argument. For instance, though EM accounts for 36% of global Gross Domestic Product (GDP), EM equities make up only 4% of the US equity portfolio. The debt proportion for the US portfolio is even lower.

However, there has been a perceptible change in the investors' view of EM. In recent years, EM assets have attracted more flows as investors have been reallocating funds from the peripheral economies of Europe. EM debt, in particular, has gained favour with investors with increased issuance, enhanced credit quality and liquidity and higher yield.

The much-improved legal, regulatory and economic climates in the EM countries, coupled with the continuing uncertainties in advanced economies, have made the EM debt market attractive. There has been a tectonic shift in the global economic environment in the last five years, which is best reflected in the proportion of top-grade rating for the developed economies. In 2007, AAA-rated economies accounted for 50% of the GDP in developed markets. Today, this number has fallen by more than half to 20%. During the same period, EMs have weathered two global crises and yet, emerged to achieve investment-grade ratings across debt issued in local markets, corporates, and sovereign debt. In September 2012, the EM corporate bonds segment crossed the $1 trillion mark and is now as big as the US high-yield market.

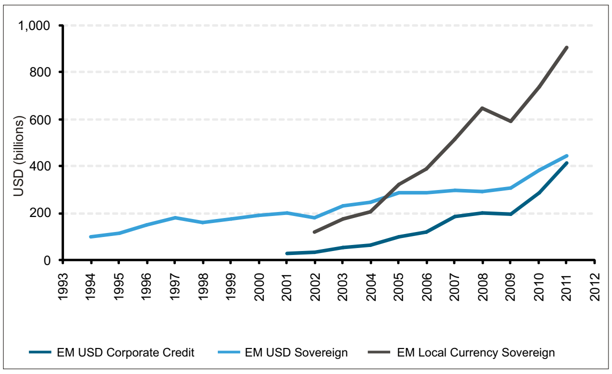
The EM equities should also continue to witness strong inflows in 2013 given their attraction, both on an absolute and a relative basis. The key to the outlook of this market will, however, heavily depend on economic reforms in countries such as China, Brazil and India.

Risk/Return profile of assets over 2002-11



Source: JPM Asset Management January 2012, CRISIL GR&A

EM debt investment over the years



Source: Scottrade Advisor Services; CRISIL GR&A; Based on JPM indices & presented by Wisdom Tree

EM corporate bonds are gaining ground: they accounted for 60% of EM debt fund launches in 2012

Emerging stock markets represent a dynamic set of investment opportunities

Asset classes: Shift in preference toward EM corporate bonds

Emerging Markets (EM) corporate bonds have emerged as a focal point for investors globally, primarily because they offer attractive yield premiums over domestic corporates. They have the added capability of augmenting diversification within a traditional fixed income portfolio. A spurt in issuance and higher liquidity provide investors an opportunity to integrate the features of EM debt into diversified portfolios. At the same time, these bonds offer investors the opportunity to participate in the growth of EM economies. Given these factors, this asset class has exhibited an impressive track record over the past few years.

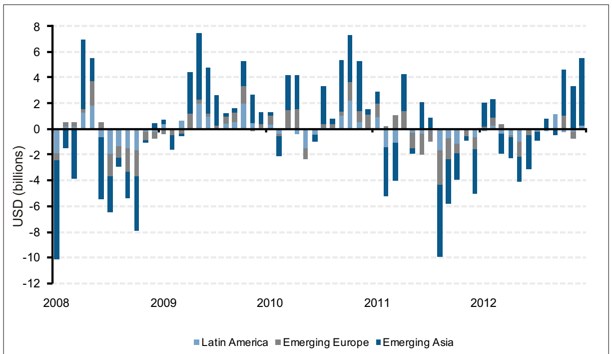
Traditionally, the term 'Emerging Market bonds' was used to refer solely to plain-vanilla government debt. However, the rapid strides made by the EM economies in the past two decades has led to the development of a wider range of options within the asset class, including inflation-linked bonds, debt denominated in local currencies, 'dim sum' bonds, and corporate bonds.

With the yield arbitrage between EM currency sovereign bonds and developed market bonds narrowing along with the stronger balance sheets of EM companies, EM corporate bonds are gaining ground: they accounted for 60% of EM debt fund launches in 2012. This has led to rising flows into local currency bonds given the prospect of a long-term appreciation of EM currencies driven by the underlying strength of these economies.

On the equity side, investors continue to look at broad EM-based equity funds rather than country/sector-specific funds to play the EM consumption demand. Emerging stock markets represent a dynamic set of investment opportunities. Further, with the improved economic outlook, EM cyclicals are expected to bounce back into favour. While at present, capital inflows are getting a boost from strong bond flows, the macroeconomic outlook for 2013-14 appear to be tilted in favour of equity investments. These benefit from a more favourable growth outlook in emerging markets.

By contrast, fixed income investments, which are currently strong, will eventually suffer from uncertainty about the end of very easy monetary conditions in mature economies. Indeed, the projected increase in private capital inflows both this year and next is solely accounted for by increased equity inflows.

Emerging Markets regional equity fund flows



Source: Institute of International Finance, CRISIL GR&A

EM countries-growth potential with underlying fiscal and monetary discipline

	Local currency 10Y yield	Local currency long-term rating	Foreign currency long-term rating	Real GDP (YoY) forecast 2013	CPI (YoY) forecast 2013
Brazil	9.60%	A-	BBB	3.50%	5.80%
India	7.80%	BBB-	BBB-	5.50%	9.20%
Russia	7.00%	BBB+	BBB+	3.30%	6.50%
Turkey	7.00%	BBB-	BB	4.00%	6.60%
South Africa	6.80%	A-	A-	2.60%	5.60%
Indonesia	5.30%	BB+	BB+	6.30%	5.10%
Chile	5.10%	AA+	AA-	4.50%	3.00%
Mexico	5.00%	A-	BBB	3.50%	3.80%
Colombia	5.00%	BBB+	BBB-	4.50%	3.10%
Peru	4.10%	BBB+	BBB	5.80%	2.80%
Philippines	4.00%	BB+	BB+	5.50%	4.00%
Poland	4.00%	A	A	1.60%	2.20%
Thailand	3.60%	A-	BBB+	4.50%	3.50%
China	3.60%	AA-	AA-	8.10%	3.10%
Malaysia	3.50%	A	A-	4.80%	2.50%

Source: Bloomberg, CRISIL GR&A

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CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

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