Emerging markets is a term so widely used it has almost lost its meaning, especially when you consider how influential these “emerging” economies truly are. Here, members of Newton's emerging and Asian equities team look at what the next year may hold for developing economies.

Since the 2008 financial crisis, emerging markets (EMs) have contributed in the region of 70% to global output and consumption growth, according to the International Monetary Fund (IMF), and many argue they haven't finished yet.1 The latest World Bank forecast has China alone accounting for 35% of the world's GDP growth over the next two years.2

However, such rapid growth can come at a price: China now has a credit gap3 of 24.6%—with anything above a 10% credit gap deemed a powerful warning signal of a financial crisis in the subsequent three years. This has widened from around 5% in 2011.4

To put China's credit gap in context with other emerging markets, Turkey's is around 7.2%, Indonesia's 9.3%, and Mexico's 9.7% (all close to the 10% threshold). Hong Kong and Singapore have the widest gaps outside of China at 30.3% and 22%, respectively.5

Douglas Reed, economic strategist in the emerging and Asian equities team at Newton, says “China is still plagued by the uncomfortable legacy of a massive state-inspired credit expansion in the wake of the financial crisis. As such, the country is attempting a tricky transition from a credit-fueled growth model that is overly reliant on investment, to one more driven by private consumption and services.”

He says China has had some success in slowing down credit growth more recently, but its debt ratio (represented by adjusted total social financing as a percentage of GDP) continues to ramp up. “This is now sitting at nearly 250% of GDP, which isn't that unusual when compared with developed countries but is very high for the emerging world. More worrying is the rate of increase, having risen by an unprecedented 113% of GDP since 2008. Past episodes of extremely rapid debt growth in other countries have frequently gone hand in hand with financial crises further down the road.”

If 2018 turns out to be a challenging year for global markets, is there a danger such overinflated ratios could come home to roost?
RAVING OR ROOSTING?

There are those who argue emerging markets are now better insulated against “sudden stops” in capital inflows as compared to the past. Rob Marshall-Lee, investment leader of the emerging and Asian equities team at Newton, agrees with this to an extent: “While U.S. interest rates are set to continue to shape the global cost of capital and currencies, we have already seen big currency moves which forced economic changes and brought current-account deficits back into line within many emerging markets.”

He says weak currencies have been a significant headwind to emerging market equities over recent years but continued steep devaluation seems implausible and appreciation may even be possible in coming years. What’s more, many EM countries have adopted flexible exchange rates and current account deficits have fallen.

Marshall-Lee says in the same way their fortunes are no longer as tied up with the economic fate of the U.S., EMs are also not so determined by commodity trajectories. “We believe a number of EMs are evolving on from the commodities story, which resulted from China’s industrialization, and are now more linked to growing domestic demand, particularly in services sectors, such as education and health care.” The progression of EM economies down this path is not equal. China has been trying to rebalance since the financial crisis, a pursuit that now seems to be bearing fruit. Growth in the manufacturing and construction sectors has declined meaningfully in recent years, while the services sector has maintained double-digit growth rates, even as the broader economy has slowed, says Reed.

Marshall-Lee continues: “Today, China is more led by consumer services than exports. It cannot sustain the level of fixed asset investment growth it underwent previously but growth continues in consumer areas. This has been helped by vigorous growth in the e-commerce sector.”

SMART REVOLUTION

Marshall-Lee says the team has been thinking for some time about the confluence of a number of factors, including “greater automation (e.g., robotics and software as a service), connected devices, the interconnectedness of cloud computing, big data, greater computer power, far greater network connectedness (mobile and broadband) and rapidly developing artificial intelligence.”

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**CHINA SECONDARY VERSUS TERTIARY INDUSTRY AS % OF NOMINAL GDP**

![Graph showing China secondary versus tertiary industry as % of nominal GDP](image-url)

Sources: Newton, Thomson Reuters Datastream, Q2 2017.
In developed markets, Marshall-Lee says these technological advancements have not only displaced manufacturing jobs but, increasingly, clerical jobs too. He believes this has been a larger culprit for “taking jobs” than emerging market labor forces, which has fed the populist sentiment espoused by Brexiteers, President Trump and radical parties in Europe, such as Italy’s Five Star Movement. “In our view, these protest votes are a cry for help from the ‘losers’ in the shift to cloud and automation. We think many of the supposed ‘solutions’ being reflected in potential anti-trade policies are likely to be self-defeating by further lowering already tepid long-term growth potential on a possibly global scale.”

The impact of these trends on emerging markets is more difficult to ascertain. “Most EM countries have the potential for ‘catch-up’ productivity, which contributes to rising trend GDP growth, as they learn technology and governance lessons from developed markets. Economic reforms are currently observable in a number of emerging markets, including India, Mexico and, to a certain extent, China and Indonesia,” says Marshall-Lee. Meanwhile, at the other end of the spectrum, the direction of travel for countries such as Turkey and South Africa is less encouraging when it comes to reform, he adds. “The increasingly authoritarian style of government in Turkey is concerning, and rising inflation in the face of weak-willed monetary policy could become more of a flashpoint in 2018.”

**FUNDAMENTALLY IMPORTANT**

Another differentiator between EM countries is their population dynamics. Marshall-Lee says an obvious statistic to highlight this theme is the forecasted change in the working age share of the population. He explains: “In countries such as India and the Philippines, there continues to be rapid growth prospects ahead and workforce growth is a key driver. In China, the workforce is more likely to contract due to the one-child policy, but we think this has been overstated as urbanization has further to run, and there is still plenty of scope for productivity catch-up in the country.”

A more volatile 2018 would not treat all emerging markets equally, so assessment of the asset class should be similarly selective, says Marshall-Lee. With this in mind, he believes a close eye on debt levels, current account balances, currency valuations and the progress of reforms should be maintained. Companies that can exploit the growing middle-class consumer and the adoption of technology should be sought out.

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**CREDIT TO GDP GAPS RELATIVE TO TREND**

![Graph showing credit to GDP gaps relative to trend for various countries from 2005 to 2015.](https://example.com/graph.png)

Sources: Macrobond, BIS and Llewellyn Consulting, June 2017.
Risks

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