Redefining Emerging Markets

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Larry Summers, former US Secretary of Treasury, commented that the upcoming US presidential election is being driven by populism and is making the US look like an emerging market nation. Although his comments were tongue-in-cheek, he is not off in looking to redefine the emerging markets of today. For the past 15 years, the BRIC countries (Brazil, Russia, India, and China) had been given the most hype as emerging markets. These four nations carried the global economy, particularly when the US housing bubble burst in 2008. However, today only one BRIC stands as emerging, India.

China has already *emerged* as the second largest economy in the world. It should no longer be considered emerging. Since the enactment of the World Trade Organization in 2000, China's economy grew at a double-digit rate for ten years, igniting the global economy. Today, China is transitioning from an industrial to a consumer led economy. China's economy is projected to grow 6.5% year-over-year; however, data out of China is always suspect. Regardless, gone are the days of double digit GDP growth.

The Chinese central bank has had major missteps over the past few years in dealing with this new growth reality. In late 2014 and in the first half of 2015, the central bank provided massive stimulus to the economy. Why would an economy supposedly growing 6.5-7% on an annualized basis need more stimulus? Either the data was not real, and or the central bank panicked. Most likely it was a combination of both. This stimulus created a bubble in the Chinese stock market; it rallied 100% from July of 2014 to June of 2015.

What followed? An incredible sell off in Chinese stocks in which the government had to intervene and halt trading on multiple occasions. The currency was devalued twice in a six month span. Finally, and most importantly, there has been a meteoric rise in debt levels. China's debt to GDP levels are now above 300%. This is up from 150% just five years earlier. The Chinese economy is slowing; maybe entering a hard landing. Capital has flown out of the country in droves. Debt levels have spiked. Now what?

This has implications for the US economy. The Federal Reserve says it remains data dependent, but the data set now includes China and the global economy. Twice the Fed has recognized the volatility in the global economy and the China in its minutes, something it has never done before. The transition and slowdown of the Chinese economy has had a major impact on other developed and developing economies, particularly those economies that are based on commodities. China has emerged!

What about the rest of the BRIC countries? Recently, Brazil and Russia can be classified as *floundering*, not emerging. Brazil's economy has been mired in its worst recession since the 1930's. Brazil's GDP was down 3.8% over the past twelve months, and is projected to be negative 3.7% this year. One in ten people in Brazil are currently unemployed. The country's economy has shown to be too reliant on the health of the global commodity market and the pace of the Chinese economy. To top it off, Brazil's political situation is a mess, with the president facing impeachment due to a corruption scandal. Longer term, with hopes of political stability and the continued population growth, Brazil's economy one day may *remerge,* but much progress needs to be made.

Russia's economy is similar to Brazil in that it is highly correlated to the price of commodities, most notably oil. The price of oil is off more than 50% over the past two years and has thrown Russia into a recession. Russia's economy has fallen 1.8% year over year. Until recently, the value of the Russian ruble fell sharply, and inflation has spiked to 13% on an annualized basis. Foreign direct invest has decreased three years in a row. Its political system under Putin is a wild card at best. Russia's economy can be classified as *cyclical*, tied to the price of oil, but clearly not emerging.

That leaves India. Its relatively new Prime Minister Narendra Modi continues to build out its services economy and is establishing better trade relations with the West. India's GDP is expected to grow 7.5% this year. It has the least exposure of the group to the Chinese economy and to the volatility in commodity prices. The country boasts the second largest population in the world. However, its infrastructure is still inept. Although 100 million smartphones were shipped to India in 2015, only 30% of the country owns one. India's agriculture is based on grain, fruits and vegetables, yet it is estimated by the UN that 40% of all produce grown in India spoils, mainly due to poor supply chain logistics and lack of food storage facilities and refrigeration. India only consumes 4% of the world's oil consumption, yet has a population that is 3.5 times greater than the US, which consumes 20%. With a stable government, and favorable monetary policy, India has the capacity to *continue to emerge*.

The BRIC wall has been broken. China has emerged. India is emerging. Brazil and Russia are floundering. Countries like Indonesia, the Philippines, Vietnam, and Mexico are the new wave of emerging economies.

Mexico and Vietnam are displacing China as the world's low cost manufacturers. The U.S. and EU are "nearshoring" manufacturing facilities into Mexico. Vietnam is becoming the de facto low cost labor market in the Asia-Pacific region, and is taking steps to open its economy. Most recently the country reestablished arms trade with the US, after more than a thirty-five year embargo. VietJet, the largest airline in Vietnam, recently announced an $11 billion order for 100 planes from Boeing. The Philippines and Indonesia have been growing their respective GDP mid-high single digits annually for the past few years as well. Foreign direct investment continues to pour into these countries, and there is focus on building out its infrastructure. The one caveat for all of these emerging economies is whether their political systems can remain stable and continue to foster growth.

How should investors play this? Despite the slowdown in China, with a long term time horizon and capital appreciation as their investment objective, investors should have exposure to emerging economies. Investing in individual companies in these regions is difficult, because immature exchanges, lack of American Depository Receipts (ADRs), and lack of access to proper information to conduct thorough research required for specific companies in these regions. So, investors can most easily access to these new emerging economies through mutual funds. One way is through the **Fidelity Spartan Emerging Market Index Fund (FPEMX).** Although 16% of the fund is invested in China, the fund offers exposure to India, Mexico, the Philippines and Indonesia. For a more targeted play, try the **India Fund (IFN).** This is a closed end fund comprised of a basket of Indian based companies. The fund is trading at a 12.4% discount to its net asset value, uses no leverage, and offers a 2% dividend yield.

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