ASIA GOING ITS SEPARATE WAY AS IT GROWS OUT OF COMMODITIES

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About a decade ago, emerging market equities were closely associated with being a play on commodities and cyclical sectors. This was the time of the commodity boom of the '00s. Latin America with its abundance of natural resources was an exciting investment destination. Commodities used to be an integral part of the MSCI EM, the benchmark to which EM investors compare their performance.

Today investors are outgrowing this perception, and the strong link between commodities and emerging markets is slowly fading.

A major force behind this transformation is the rising weight of Asian markets. Asia has grown in prominence. With its change into a higher growth and lower risk profile relative to the rest of EM, Asia is pushing growth sectors like tech and consumer under spotlights, and increasing their weight. Emerging markets indices are subsequently following and reflecting this adjustment.

MSCI EM is increasingly dominated by non-cyclical sectors. Cyclical sectors such as energy are gradually declining. The commodity part has fallen to about

15%, when in the past it used to be consistently above 30%, peaking at 37% in 2008. Today technology, consumer, telecoms and healthcare make up more than 50% of the MSCI EM. Notice that the technology sector is around 23% of MSCI EM, a level even higher than the share of tech sector in S&P 500, and mainly represented by technology companies originating in Asia (Samsung, TSMC, Tencent, Alibaba, Baidu, Hon Hai). As growth sectors expand and cyclical sectors decline, the MSCI Index is gaining in earnings visibility.

Investments naturally flow towards well-managed companies with higher and more predictable earnings.

This development is associated with an interesting investment insight because it is leading us to the unique conclusion that Asia may be going its own separate way from the rest of EM. In the future, there may be a need to think of EM in two buckets as opposed to only one: Asian markets, possibly combining developed and emerging markets (more on that below), and non-Asian emerging markets.

The first thing that jumps as the most striking difference between Asia and the rest of the EM is the consistently high savings rates and investment rates. Although there is variation across countries and over time, Asia as a whole is indeed a high-saving, high- investment, and high-growth region.

Saving and investment rates of East Asia and Latin America used to more or less equal around mid 1960's, however by 1990 East Asian rates became almost double Latin American rates.

When the Asian crisis hit in 1997 – a crisis that resembled a currency crisis when the root cause was unsustainable debt levels – there was a successive slowdown in investment rates. Some countries (Thailand, Indonesia, Korea) were more affected from the crisis than others. Most have resumed investments over time but only at variable rates. The blessing was that there was no change at Asia's strong suit and core strength: high saving rates. Countries that were more struck by crisis saw their savings rates remaining stable accompanied by lower investment rates, leading to a current account surplus. Countries that recovered much faster (China) saw their savings rates increase substantially with their investment rates also picking up, however more slowly than the savings. This again led to a current account surplus. Those surpluses have been sticky to this date. They are healthy because they provide a cushion to local currencies when under pressure from the rising dollar.

This helps to explain why the region as a whole continues to outperform other parts of the emerging world.

As an example, for Latin America's economies to grow at 5% in the future, they should invest around 25% of GDP. Some countries approached these investment levels during the commodity prosperity of 2003-13. But now that the commodity phase is over, investments rates have slowed down remarkably and same thing can be said for growth.

Latin American governments traditionally save too little, both at good times or bad times. Either for political, historical or cultural reasons, they tend to favor current spending over public investment. Whereas some countries in Asia endlessly built infrastructure that lead to a visible increase in private investments, in Latin America subsidies and salaries for government employees took regularly priority over roads, energy and water.

The region's low tendency to save has historic origins. Generations of Latin American citizens have seen their savings vanish, either through inflation (Peru, Mexico, Chile in previous decades) or by governments simply seizing them (Argentina, Brazil, Venezuela).

Savings rates in Asia average about 32% of GDP, while the saving rates in Latin America are around 19%. What happens in Latin America is on some level the exact opposite of what happens in Asia. It leads to current account deficits. Local currencies become unstable, leading to capital flight and low growth.

Similarly, education trends also separate Asia from Latin America. Every fast growing Asian economy has seen its literacy rate and university enrollments go up. This is very different from Latin America. In Asia, there is a historic tradition of literacy and hard work – examples include Japan, Korea and China. In other cases, history of legal framework and institutions plays a role. Institutions left by the colonial powers in the 20th century (especially the British Empire in India, Singapore, Hong Kong and Myanmar) were more suited to advance to a modern economy than the Napoleonic codes adopted by most Latin and African nations.

Our starting point for this article was that the link between EM and commodities might be fading. Without any doubt, Asian economies made an honest attempt to diversify their economies away from commodities, they were firm in adapting best technologies, and they industrialized fast.

It is entirely possible that investors will one day look at EM in two separate buckets: Asia and non-Asian emerging markets.

On the Asian markets as a group, there are several markets that the MSCI considers developed (Singapore and Hong Kong, especially) but which are deeply intertwined with mainland China and other EM. Then, there are two markets which should be considered developed by any objecting measure (Korea and Taiwan) but remain classified in EM. For the future, it might be easier to combine all these Asian countries in one single geographical area, and leave the other EM, with their traditional dependence on commodities, to EMEA and Latam.

If one day this thought becomes reality and the region separates itself from the rest of EM, hopefully the Chinese knot – commonly known as the Chinese lucky charm – will help to keep and preserve Asia's good fortune.