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CORRECTED - Emerging markets come of age amid Greek woe

Fri Jan 29, 2010 6:31pm GMT

Corrects paragraph 9 to say global and emerging equities, not bonds, fell during the past week. Fixes typo in paragraph 10.

By Sujata Rao - Analysis

LONDON (Reuters) - Emerging markets may be facing a massive capital influx thanks to crises in Iceland and euro-zone member Greece that have shattered prior assumptions that nominally developed economies are safer places to invest.

Against a backdrop of the inexorable rise of new economic powers like China and Brazil and the prospect of at least several years of anaemic growth and heavy debt burdens across the West and Japan, it is not difficult to see why there's a sea change in investor attitudes.

The shift is already clear from debt-insurance costs and bond yields, traditionally higher in emerging markets to reflect the perceived market, economic and political risks.

But this year it has become costlier to insure Greek and Irish debt against default than Poland or Brazil, while Japanese credit default swaps, used to hedge against default, rose above China's at the start of 2010.

And this week, investors were willing to receive 100 basis points less for 10-year Hungary risk versus five-year bonds from Greece. In an even starker comparison, Hungary -- itself bailed out by the IMF in 2008 -- has a euro issue outstanding that is trading over 150 bps tighter than Greece's new benchmark.

"This crisis has blown the division between emerging and developed; the underlying rationale has changed," said Phil Poole, head of EM research at HSBC.

"Everything I see across asset classes suggests there is a move in train to rebalance portfolios in favour of higher weight in emerging markets."

Data from fund tracker EPFR Global shows emerging bond and stock funds took in a record $75 billion in 2009, next only to U.S. bond funds. In contrast U.S. stock funds lost $42 billion.

Even more tellingly last week, as Greek jitters mounted, emerging local currency bonds saw an all time inflow record, EPFR said, though emerging and global equities fell.

"I wouldn't say the problems in Greece are necessarily a direct catalyst but they have focussed attention on the strong fundamentals in emerging markets and difficulties the developed world is facing coming out of the credit crunch," said Mike Gomez, who oversees $31 billion in emerging bonds at PIMCO.

"There was a large perceived difference in the risk you took investing in emerging markets...What you have now is 30 percent of the euro zone trading at credit levels similar to Brazil."

INVESTMENT GRADE

To be sure, not all emerging markets are doing well. And hardly anyone expects them to withstand a serious risk downturn. But overall, developing economies were in pretty good shape when the U.S. credit crisis exploded on to world markets in 2008.

Already growing twice as fast as their richer peers, these countries' public debt ratios and budget deficits are on average half the levels seen across the developed world.

Rating agencies have rewarded this strength with about 30 positive ratings actions since October versus ratings or outlook cuts handed to developed markets like Greece, Ireland and Japan.

The spate of upgrades has raised the average rating on JP Morgan's 37-country Emerging Markets Global Diversified index of local currency bonds (GBI-EM) to investment grade. JPMorgan's EMBI Global index is also on the cusp of investment grade.

An investment grade rating usually opens an asset class to a broader spectrum of investors like U.S. institutional pension funds, which according to a recent RBC report have just 2 percent of their $5 trillion assets in developing markets.

Much future crossover interest will centre on the $5.5 trillion local currency emerging bond market, seen in the past as the preserve of the most avid risk chasers.

"You are talking of a group of countries with BBB+ local currency ratings but the average five-year yield on JPM's GBI-EM local index is 7.4 percent," PIMCO's Gomez said.

That's 5 percent over U.S. and German 5-year yields.

DECOUPLING DEBATE BACK?

Emerging markets resilience has rekindled some talk of decoupling -- the view emerging markets are now strong enough to shrug off weakness in advanced economies. That theory was discredited in 2008 when emerging stocks lost half their value in the wake of falls in London and New York.

Financial market decoupling is unlikely in a globalised world but real economies in developing and developed nations do seem on divergent paths in terms of growth, says Eswar Prasad, a senior fellow at the Brookings Institute in Washington DC.

"The underlying concept has staying power...the growth rates we see in emerging markets even in this environment imply a structural rather than cyclical kind of decoupling," he said.

This structural growth outperformance should be reflected in corporate and personal earnings, boosting stock markets, real estate prices, tax receipts and ultimately currencies.

Greater volatility is a likely consequence for the relatively small asset class -- MSCI's emerging stock index for instance has a market capitalisation less than a third of the U.S. S&P500. Already many emerging central banks, battling currency strengthening, have introduced capital controls.

"This will have important policy implications in that (developing nations) will have to work to improve financial systems to cope with volatile capital inflows," Prasad said.

(Additional reporting by Alex Chambers; graphics by Scott Barber, editing by Patrick Graham)