



Newton Fixed Income
October 2009
Carl Shepherd
No. 294

The term 'emerging markets' is not obsolete; it just needs to be recalibrated

Newton global bonds and currencies strategy: The term 'emerging markets' is not obsolete; it just needs to be recalibrated. We believe there are highly attractive opportunities for bond and currency investment in emerging countries, particularly those with strong resources and improving political conditions.

Some commentators have suggested recently that the term 'emerging markets' is now obsolete, given that emerging economies account for half of global output, given that emerging financial markets are now large and liquid, and owing to the fact that patterns of volatility, corporate governance and government policies in emerging markets are very similar to those that are evident in developed markets.

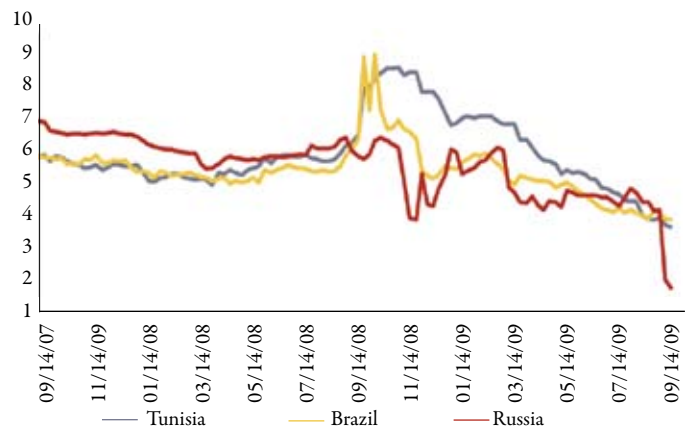
There is no precise definition of what constitutes an 'emerging market'. One study¹ determined that an emerging market is one characterized by relatively low per capita incomes, net capital inflows and relatively underdeveloped financial markets. In benchmark terms, the JP Morgan EMBI+ Index (a commonly used emerging-market benchmark) requires that a country be rated Baa1/BBB+ or below to be classified as an emerging market. Elsewhere, an emerging market has been defined as a country where 'politics matter at least as much as economics to the market'.²

Political risk is arguably the most difficult risk to evaluate, and investors face the further challenge that, at times of heightened risk in an emerging market, they may naturally be in receipt of the least information in a kind of 'rigged game'. A mischievous schoolboy would naturally choose to sit towards the back of the classroom or the school bus; similarly, in emerging markets, common features such as a government-owned press, and poor communication and transport infrastructure, may assist in allowing maladministration or

the misuse of funds, because they make it more difficult to monitor bad practice and to hold politicians to account for their actions.

The majority of government debt defaults occur following a change in power or political leadership. Rating agencies, whose assessment criteria are generally skewed towards quantifiable econometrics, inevitably find themselves 'behind the curve' when dealing with unquantifiable risk; assessing political risk equates to trying to assess a government's propensity to meet its debt obligations rather than its ability to do so. Generally, the markets are better than the rating agencies at pricing in the more unquantifiable risks. The chart below illustrates the changes in spread between three short-dated, 'BBB'-rated government bonds since the beginning of 2008. Throughout the financial crisis and, in its aftermath, the bonds have all maintained investment grade ratings.

GOVERNMENT BOND YIELDS



Source: Bloomberg
Past performance is not a guide to future performance.

The financial crisis has caused a loosening of the correlation of emerging-market government bonds as well as greater discrimination by investors between different industries. This is a trend that has the capacity to continue into the future,

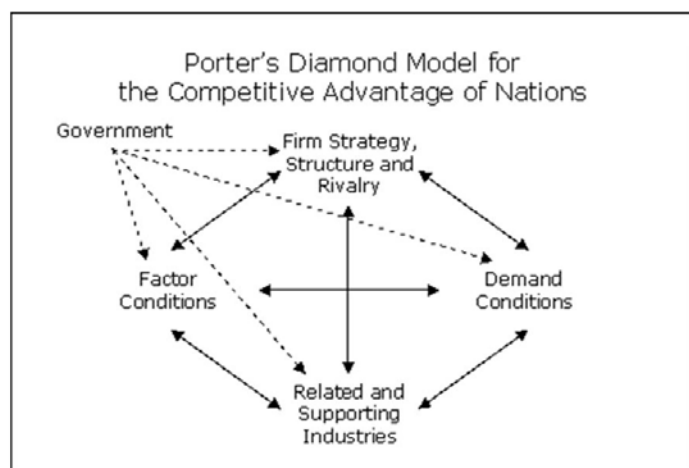
¹ Bordo and Eichengreen (2000)

² Tony Jackson, Financial Times 05.10.09 (non-attributed quotation of a political analyst)

and we believe that there is good reason for thinking that it should do so. There are great differences in the resources (both natural and human) available to different emerging countries and it is feasible that certain resources will be in greater demand than others during different periods.

Those who write about political risk may come across as paranoid conspiracy theorists, who envisage a hidden message in every emerging-market government action or announcement. However, the Newton fixed income team has a positive view about the opportunities for investment in emerging markets. Evaluating economic data remains critical to making emerging-market investment decisions, but we believe also that our long-term thematic approach is ideally suited to identifying the enduring 'stories' that will support investment in particular emerging-market countries.

Aspects of the 'diamond model', devised by Michael Porter in 1990, of the competitive advantage of nations offer a simple way of incorporating 'stories' into investment decisions.



Source: www.valuebasedmanagement.net

Porter stated that: "According to standard economic theory, factors of production – labor, land, natural resources, capital and infrastructure – will determine the flow of trade. A nation will export those goods that make most use of the factors with which it is relatively well endowed." It is not difficult to see how this concept has been supportive of emerging-market investment in recent years.

Taking into account the comments made above about political risk, it is fair to say that in Porter's model the largest common

failing of emerging-market governments is inconsistent or populist government intervention, and also the neglect of other fundamental areas, such as transport infrastructure, education and property rights.

It is important to realize that emerging-market classification is sometimes made on non-economic grounds, and that a realistic view needs to be taken into account of the appropriate level of return required for taking on an often unquantifiable level of risk. Investors need to be realistic about the timeframe required in order to overcome risk in the pursuit of return. Our *more government* theme is pertinent to the role of emerging-market governments, owing to the necessary improvements by those governments in areas such as infrastructure and education that will assist the 'convergence trade' with the developed world. The creation of 'bigger government' could be market-unfriendly and lead to heightened volatility in emerging financial markets. However, during the recent economic downturn, some of the more centrally planned economies have actually been the more protected and their financial markets the more lucrative for investors.

In a wider investment sense, government bond yields are important in establishing the minimum return on investment within a particular country, based on the concept of the 'sovereign ceiling'³. Our recent emerging-market government bond purchases have generally been focused upon economies with strong natural resources. We generally favor investment in areas that are 'long' of 'stuff' and short of people because there will generally be no shortage of labor in the world owing to the demographic characteristics of many emerging-market countries. We believe that restraints on economic growth are likely to be resource-based (including raw materials, water and energy) and we anticipate that there will continue to be increasing demand for these resources as the world's population increases.

We believe that the most attractive emerging-market investment opportunities exist in countries that are resource-rich and in which there is the prospect of improving political conditions.

³ Durbin and Ng, 2005

Past performance is not a guide to future returns. The information contained within this document should not be construed as a recommendation to buy or sell a security. It should not be assumed that a security has been - or will be - profitable. There is no assurance that a security will remain in the portfolio. The opinions expressed in this presentation are those of Newton Capital Management Limited and should not be construed as investment advice.

'Newton' refers to the following group of affiliated companies: Newton Investment Management Limited, Newton Capital Management Limited, Newton International Investment Management Limited, Newton Capital Management LLC and Newton Fund Managers (CI) Limited. Assets under management include assets managed by all of these companies except Newton Capital Management LLC, which provides marketing services in the U.S. for Newton Capital Management Limited. Except for Newton Capital Management LLC and Newton Capital Management Limited, none of the other Newton companies offer services in the U.S. Newton Capital Management Limited is an investment management firm authorized and regulated in the United Kingdom by the Financial Services Authority in the conduct of investment business and is a wholly owned subsidiary of The Bank of New York Mellon Corporation. Registered in England no: 2675952. Newton Capital Management Limited is registered in the United States as an investment adviser under the Investment Advisers Act of 1940.