Capital flows into emerging markets

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2010 marked a turning point in global asset-allocator sentiment towards emerging markets. Over $80 billion flowed into emerging-markets equity funds, while approximately $80 billion flowed out of U.S. equity funds. This is just the beginning of a long-term secular trend, supported by fundamentals, as the debt and currency crises of "developed" markets push investors out and the allure of emerging-markets demographic and socio-economic factors pull investors in.

There are obvious and compelling factors supporting a change in global asset-allocation models and increased weightings towards emerging markets. For starters, 52% of global GDP (PPP adjusted) already occurs in emerging markets and 75% of the world's land surface is situated in emerging markets (13% is in Russia, the world's largest country). 85% of oil and 89% of gas reserves are held in emerging markets (Russia has 25% of global gas reserves). 87% of the world's population resides in emerging markets. 74% of global currency reserves in US$ terms are held by emerging-markets central banks, while 90% of global external debt is owed by developed countries.

Looking at these facts, thinking about the trends and projecting into the future, it is hard to understand why the average global investor's exposure to emerging markets is just 6%.

Valuations are based on future cash flows and markets are "forward looking", so investors need to go to where the economic center of gravity will be in the future, not sit where it was in the past. China has already surpassed the U.S. as the largest automobile market. GDP growth in emerging markets will likely exceed 7% in 2010, almost 3 times developed-country growth rates. From a sovereign balance-sheet perspective, developed-country debt burdens will lead to higher taxes and lower growth. With most of the world's land surface come most of the world's hard assets. Hard assets are particularly good to hold in current times, as global reserve currencies are managed by fiat and debased with "quantitative easing".

The growth-rate differential is likely to grow as emerging-country populations migrate from farms to cities and start producing larger volumes of higher value-added goods and services. Technology is distributing knowledge faster than ever in human history, creating new wants, needs and consumption patterns. Health, safety and education standards are improving rapidly and life expectancy in emerging markets is increasing.

These factors are all drivers of higher consumption and investment. Healthy smart people earn, invest and consume more than unhealthy, uneducated people. Infrastructure will grow rapidly to keep up with and support the fast pace of economic growth in emerging countries. Export infrastructure was critical for emerging markets in the past, but going forward, domestic infrastructure will become increasingly more important. Trade between emerging countries has grown more rapidly than exports to developed countries, so emerging countries are correct to reduce dependency on developed markets and focus on intra-emerging-markets trade. Commodity price growth is correlated with global growth in GDP per capita. As GDP per capita returns to pre-crisis levels and as emerging countries transform from agricultural to urbanized societies with declining birth rates, consumption patterns are becoming more commodity intensive and commodity prices are likely to continue rising in their "super cycle" secular trend.

As global investors adjust their asset-allocation models to avoid the fiat currencies and debt-induced recessions of developed markets, capital will be flowing into emerging markets at an increasing rate. Conventional definitions of "quality" in the "flight to quality" and the means to achieve capital preservation will increasingly utilize exposure to emerging markets. The lower growth prospects of developed markets, given their debt, deficits and devaluation, make emerging markets like Russia with its huge financial reserves, higher growth rates and abundant hard assets very attractive.

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