

The Future of Emerging Markets

Q&A with Kunal Ghosh and Lu Yu, CFA, CIPM

Emerging market equities have delivered significant returns during the past ten years, with an annualized return of more than 14%.¹ That compares to an annualized return of less than 3% for the S&P 500 Index over the same period. Has this winning streak run its course, or does it still have legs? Kunal Ghosh and Lu Yu, portfolio managers for the Emerging Markets Systematic investment strategy, discuss the changes taking place in emerging market countries that could continue to drive these equities higher.

Q: Emerging market equities have delivered strong returns over the past decade. What factors have been driving this performance?

A: The emerging markets story began almost thirty years ago. In the mid-1980s, developed economies started on a debt-fueled consumer spending binge that lasted more than two decades. This provided an incredible opportunity for developing economies. Deng Xiaoping recognized that by opening China's economy, the country's low-cost manufacturing base could power an export-oriented boom. The country was a direct beneficiary of the huge growth in developed market economies. In 1986, China's GDP was \$298 billion. In 2010, it was \$5.9 trillion, which reflects an annual growth rate of over 13%.² Other emerging market countries recognized that same opportunity and moved to capitalize on the demand for manufacturing and goods to support growth in the developed world.

To sustain this growth, improvements in infrastructure were also needed. Roads, plumbing, electricity, schools—emerging market countries invested in building out these fixed assets. For instance, in China the total investment in fixed assets increased over 13-fold in just 15 years.³ This build-out in infrastructure, as well as increased demand from developed markets, contributed to a tremendous need for commodities, which was another plus for many resource-rich emerging market countries.

An expanding manufacturing base, investment in infrastructure and strong demand for commodities combined to catapult these economies forward, and the market rightly recognized this transformation.

¹ MSCI Emerging Markets Index from January 1, 2002 to December 31, 2011

² Source: World Bank

³ "China Statistical Yearbook 2010." Source: China Statistics Press.

Q: Emerging markets rebounded more quickly from the 2008 financial crisis than did developed economies. How were these countries able to respond so effectively?

A: To understand emerging market performance in 2008, one needs to go back in time and first study the emerging market countries in the 1990s. Emerging markets did not do well in that decade, due largely to poor fiscal controls and weak balance sheets. For example, during the 1990s, Brazil had an average inflation rate of 549% per year.⁴ Indonesia had a government debt-to-GDP ratio of 100% in 1999, which resulted in serious financing issues.⁵ High inflation and weak balance sheets culminated with the Asian crisis in 1998 and serious currency devaluation in countries such as Brazil. As a result of the crisis, balance sheet strength and improved fiscal conditions were made a priority in many of the emerging countries. Brazil got its hyperinflation under control through a series of political, fiscal and economic reforms. At the end of 2008, the country's inflation rate was down to 5.7%.⁶ After experiencing their own financial crisis in 1997, many of the Asian Tigers such as Indonesia, South Korea and Thailand de-levered their economies. In 2008, Indonesia's government debt-to-GDP ratio had fallen to a much healthier 29%.⁷

That takes us to the recent financial crisis. An immediate impact of the global economic crisis was that the capital flow into emerging market countries dried up, dropping from over US\$600 billion in 2008 to an estimated US\$195 billion in 2009.⁸ The issues of slowing growth, high

⁴ Source: IBGE, Brazil's National Statistics Agency.

⁵ Last modified July 24, 2007, "Indonesia's Debt and World Bank Assistance." Source: World Bank.

⁶ Source: IBGE, Brazil's National Statistics Agency.

⁷ Last modified July 24, 2007, "Indonesia's Debt and World Bank Assistance." Source: World Bank.

⁸ Source: Bank of Indonesia

government debts, rising unemployment, and aging populations within developed economies such as the United States presented headwinds for emerging market countries, which in the past had been much more reliant on the health of developed markets. However, because of earlier fiscal discipline, countries such as China, Brazil and Indonesia were able to stimulate economies on their own with low interest rates and massive stimulus packages. The stimulus packages, which were targeted at increasing domestic consumption, were over \$6 billion in Indonesia, \$20 billion in Brazil, and a whopping \$586 billion in China. From September 2008 to September 2009, these stimulus measures helped create more affordable financing as interest rates fell from 9.25% to 6.50% in Indonesia, from 13.75% to 8.75% in Brazil, and from 7.2% to 5.3% in China.⁹ Emerging market countries were therefore in a much better position to weather the challenging economic conditions on their own, and much less reliant on developed market economies than in the past.

Q: Fiscal discipline and investment has delivered for emerging economies up to this point. How will it contribute to future growth?

A: A strong infrastructure has significant long-term benefits, such as a growing manufacturing base, an educated workforce and more mobile, and therefore more easily employable, societies. The build-out of fixed asset infrastructure in China, which has been strong over the past 15 years, continues today, particularly as the population becomes more urbanized. Brazil also continues to invest in infrastructure, with estimates in excess of \$800 billion in infrastructure spending as the country prepares to host the 2014 FIFA World Cup and the 2016 Summer Olympic Games.¹⁰ Countries such as India and Indonesia are also ramping up their infrastructure spending.

The workforce and infrastructure evolutions are contributing to the growth of more substantial middle classes in many emerging countries. For example, the proportion of Brazil's population that is considered to be middle class has grown dramatically over the past

decade.¹¹ History tells us that in order to achieve long-term success, an economy needs significant contribution from domestic consumption. Fixed asset investment has always been a harbinger of economic growth, but has never successfully carried an economy in the long run. Sustained economic success of emerging market countries depends upon continued development of a strong consumer base. That consumer base is typically rooted in a significant middle class.

Q: The development of a substantial middle class appears critical to long-term success of emerging market economies. How will this change impact the performance of these economies?

A: Most important in our opinion is growth in consumer spending. Specifically, an expanding middle class tends to increase consumption in the consumer discretionary space, as these consumers have more (and growing) discretionary income and low levels of debt. So, while demand from developed countries has declined, consumer demand from within these emerging countries has grown substantially. Consumers in emerging markets are expanding their regular purchases well beyond staples to buy cars, cell phones and even luxury products. The wealth that has accumulated over the last two decades is now circulating throughout the economies.

Recognizing the benefits of consumer spending, governments in emerging countries have instituted policy changes that promote more consumption and increase the size of the middle class. This is a significant change for many cultures that have historically been more likely to save than to spend. Brazil has embarked on a program to increase home ownership through its "Minha Casa, Minha Vida" (MCMV) housing program, which allows for lower income homebuyers to receive subsidies from the Brazilian government and paves the way for new middle class entrants.¹² China recently reduced its income tax burden by raising income thresholds and lowering rates, lightening the tax burden on mid- and low-income earners.¹³ As a result of the expanding size and wealth of the middle class, the proportion of global

⁹ Last modified November 9, 2008, "China Plan 586 Billion Economic Stimulus." Source: New York Times. Last modified February 25, 2009, "Stimulus package approved, raised." Source: The Jakarta Post. "Brazil: Despite Slowdown in Economic Growth, Labour Market Proves to be Resilient." Source: G20 Statistical Update, International Labour Office. Interest rates source: FactSet.

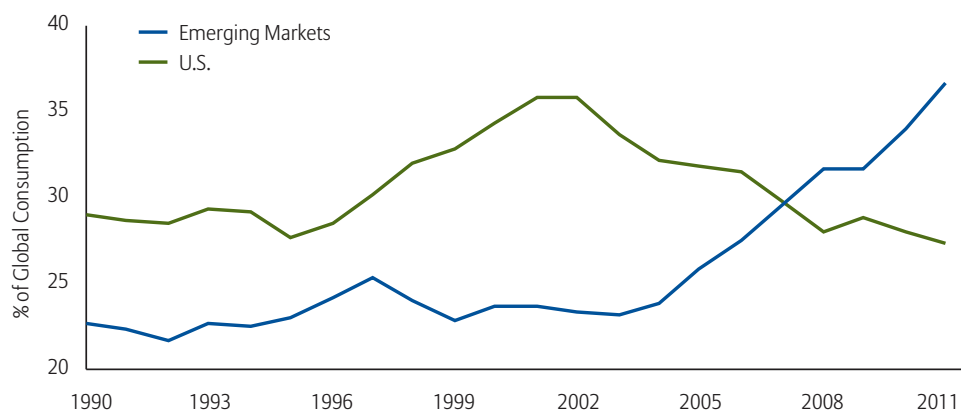
¹⁰ Last modified January 2010, "Infrastructure Investment in Brazil." Source: Financier Worldwide

¹¹ Last modified: September 2, 2011, "The rise of the mall in Brazil." Source: The Globe and Mail.

¹² Last modified June 15, 2011, "Brazilian Homebuilders and Real Estate Brokers." Source: Credit Suisse

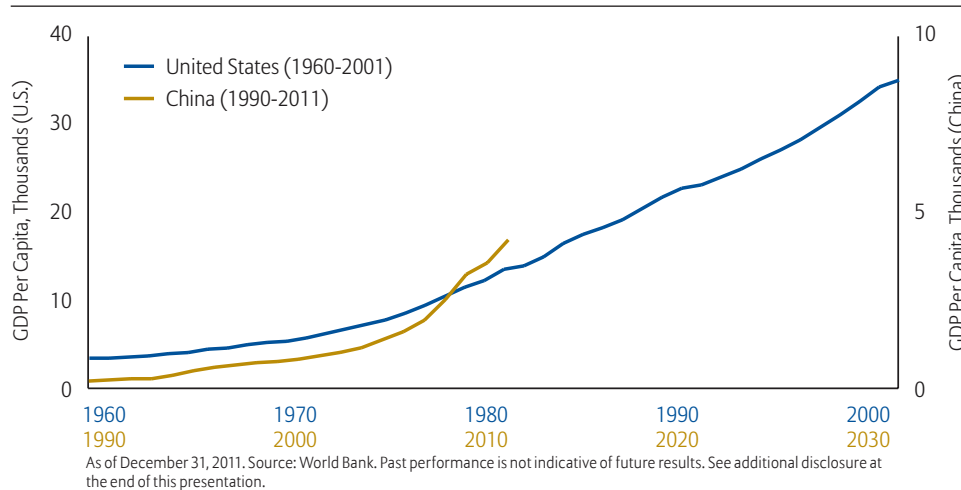
¹³ Last modified December 23, 2011, "The Decision on Amending the Individual Income Tax Law Passed by the NPC Standing Committee." Source: China Taxation News.

Figure 1: Emerging Markets is the New Leader in Global Consumption



As of December 31, 2011. Source: JP Morgan and Allianz Global Investors Capital. Past performance is not indicative of future results. See additional disclosure at the end of this presentation.

Figure 2: Growth in GDP – U.S. vs. China (in U.S. Dollars)



consumption from emerging countries has actually surpassed the proportion from the United States. (See Figure 1)

There are similarities to the United States during the Baby Boom generation and emerging market countries, such as China, in the recent two decades. (See Figure 2) During the 1960s, the United States was undergoing an explosion in the size of the population and its presence in the world economy was increasing. The same holds true for China beginning in the 1990s. Expectations are that the growth in GDP per capita will continue its ascension as the size of the middle class continues to expand.

In addition, while income in emerging countries has been rising, household debt as a percentage of GDP is relatively low. (See Figures 3 and 4) Borrowing costs in many emerging market countries are also at or near historic lows, suggesting plenty of capacity for increased discretionary spending. Consumer credit is also in its infancy, suggesting greater potential for the middle class to take out loans for bigger ticket items such as automobiles and mortgages for homes. While consumers in the United States are tapped out with nearly 100%

consumer debt to GDP, the ratio of consumer credit to GDP in China and Indonesia, for example, is estimated to be in the high single-digits to low double-digits.

These factors indicate to us that increased demand from growing middle classes will likely drive emerging market economies and markets in the coming years.

Q: Investor interest in emerging markets has been increasing. What do you view as the best way for investors to capitalize on this opportunity?

A: We believe that profiting from this transformation will be challenging, more challenging than many investors realize. The temptation is to simply increase exposure to emerging markets across the board. In our opinion, that approach is not likely to produce the best results.

The MSCI Emerging Markets Index (MSCI EM Index) is more heavily weighted toward the commodity and materials industries than the consumer space. While commodities and materials have done well

Figure 3: Projected Growth in Disposable Income, 2010-2015 (% Change)

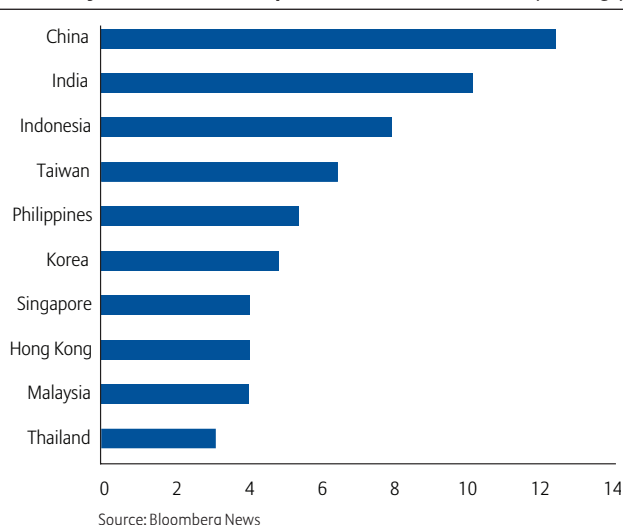
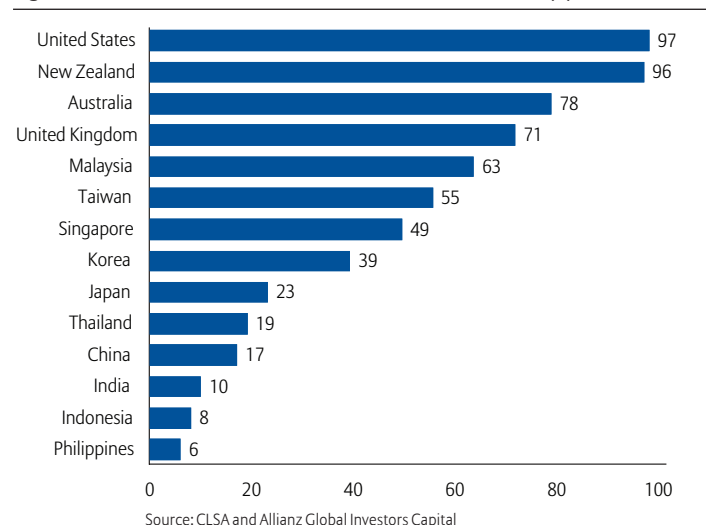


Figure 4: Consumer Credit as a Percent of GDP, 2009-2010 (%)



in recent years, due to fixed asset investment and demand from developed markets, our research indicates that future growth will likely be stronger in other areas. Investors who buy the benchmark to gain access to emerging markets will unwittingly be investing a higher level of each dollar in energy and materials sectors. For example, energy and materials sectors make up 27.3% of the MSCI EM Index, while consumer discretionary and staples are only 16.2% of the Index. In particular, stocks such as Gazprom, Petrobras and Vale are among the biggest weights in the MSCI EM Index, which tend to be geared toward developed market demand. The converse is true in the United States, where energy and materials sectors comprise 15.8% of the S&P 500 Index and consumer sectors are 22.2% of the Index.¹⁴ Our belief is that the consumer sectors should benefit as the size of the emerging market middle class increases.

In addition, many of the consumer companies have lower market capitalizations, whereby the relative inefficiency of the small-cap market

¹⁴ Source: Factset. Data as of December 31, 2011.

creates a potential for mispricing. As an example, the average market capitalization of consumer discretionary stocks in the MSCI EM Index is \$5.2 billion versus an average of \$22.2 billion for the energy sector.¹⁵ In-depth analysis is more likely to uncover these opportunities, rewarding the investor who performs rigorous research in this inefficient space. We believe active managers have the ability to exploit these inefficiencies, potentially benefiting portfolios with a greater focus than a broad-based equity index such as the MSCI EM Index, which has over 800 securities.

An increased focus on consumer-related stocks should prove advantageous as this secular growth story continues. Opportunities focused on the rising middle class are likely to be more targeted, especially as investors continue to realize the significant consumer demand. We anticipate the emerging markets middle class theme will be a key driver of investment results for the coming decade.

Kunal and Lu, thank you both.

¹⁵ Source: Factset. Data as of December 31, 2011.

Disclosure

Allianz Global Investors Capital ("AGIC") was formed from the combination of three affiliates: NFJ Investment Group ("NFJ"), Nicholas-Applegate ("NACM"), and Oppenheimer Capital ("OpCap"). In July 2010, all employees of NACM and OpCap became employees of AGIC, and the transition of management of client assets from NACM and OpCap to AGI Capital was initiated. AGIC provides oversight with respect to the investment management services provided by NFJ, as well as non-investment functions including marketing, operations, technology, legal/compliance, and client service. AGIC and NFJ are SEC registered investment advisers.

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