

EMERGING MARKETS OF TOMORROW

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*This week Professor Siegel and I chatted with Gavin Serkin, Emerging Markets (EM) Editor at Bloomberg News. Gavin recently wrote a book called *Frontier: Exploring the Top Ten Emerging Markets of Tomorrow*. The book contains an excellent narrative of Gavin's trips and is well worth reading for anyone exploring investments in the region. We also spoke to Worth Wray, Chief Strategist at Mauldin Economics, whose current focus is also on EM and the implications of a stronger U.S. dollar.*

The Future Emerging Markets Gavin polled top-ranking money managers for their hit lists of countries for investments over the next five to ten years, and then he asked if he could travel to those countries with them. He ended up creating a list of top 10 countries whose dynamics today may suggest potential for sustained growth in the future. The top four countries on his list—based on opportunities for long-term allocations—are Nigeria, Vietnam, Argentina and Saudi Arabia. Optimism for Nigeria, Gavin's top-ranked country, stems primarily from the potential for a rise in its consumer base due to its healthy demographics. According to the United Nations, Nigeria has the potential to become the third most populous country in the world by 2050¹ and also boasts the highest percentage of people under the age of 15 today. This demographic trend, along with Nigeria's rich mineral wealth, will likely serve as a tailwind for economic growth in the years ahead. Further, Nigeria is coming from such a low base—in terms of low income, lack of disposable wealth, inefficient taxation systems and bad infrastructure—that there are bound to be many changes over the years, and this growth could eventually rival China's.

Saudi Arabia Culture Shock We found Gavin's discussion on Saudi Arabia particularly noteworthy. Saudi Arabia has been closed to foreign investors and is potentially opening up as early as this year. Given Saudi Arabia's size, Gavin speculated that the region could skip inclusion into the frontier indexes and instead be added directly to broader emerging market indexes. Again, because of its size, it could eventually achieve greater weights in these indexes than such countries as Turkey.

The Biggest Unknown: Governments In discussing the single most important factor in determining the future for these frontier and emerging markets, both Gavin and Worth brought up the relevance of their governments. In the case of Nigeria, while president-elect Muhammadu Buhari is relatively untested in his capacity of serving as a market friendly president and has previously had a track record of being a military dictator in the 1980s, if successful in his fight against corruption, he could set the stage for significant growth in the years ahead.

China's Great Leap Forward Worth Wray offered a very interesting perspective on China. Together with his colleague John Mauldin, he is about to publish a book on China called *A Great Leap Forward*. Worth noted the unexpected performance in Chinese equity markets since last summer. He mentioned that a [Renminbi \(RMB\)](#) devaluation may be a forced outcome for Beijing in order to sustain this equity market rally and to combat the competitive pressures from the strong U.S. dollar and weak euro and yen. Worth believes the Chinese government must moderate growth expectations from above 7% to between 4% and 5% and do whatever it takes to transition to a more stable path. The alternative is for the government to drive Chinese growth through credit expansion and excessive monetary stimulus, which he believes could lead to a financial crisis the size of which would make the 2008–2009 U.S. financial crisis pale in comparison.

Strong U.S. Dollar and Its Implications Worth pointed to a speech by [Federal Reserve \(Fed\)](#) vice chairman Stanley Fischer in late 2014, where he said that the Fed will focus on the U.S. economy but has a responsibility to communicate its policy intentions to the rest of the world such that policy makers can prepare in advance. The Fed's [forward guidance](#) and communication has steadily been trending toward [tightening policy](#), although this has been mixed with softening assessments of the U.S. economy. Consequently, expectations for the forward [curve](#) have come down, and this might provide a reprieve to EM nations that may still be fragile in an environment of higher U.S. rates. Separately, Gavin commented on the biggest surprise in the markets year-to-date (YTD): Russia, whose equity performance has caught markets off guard. Not only is Russia one of the top-performing markets in EM YTD, but its currency has also been appreciating. U.S. investors have been caught short on this trade and many are starting to go back in full force, driving performance even higher. Gavin also believes there is no indication that sanctions will be ratcheted up any further.

Fed Future Trajectory Wrapping up this week's conversation, Professor Siegel reiterated his belief that the Fed will continue to remain accommodative on the [monetary policy](#) front, given U.S. dollar strength, the weak payroll report and lackluster [inflationary](#) pressures. *Read the Conversations with Professor*

Siegel Series [here](#).

¹Source: United Nations, Department of Economics and Social Affairs, World Population Prospects: 2012 Revision, June 2013.

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DEFINITIONS

Renminbi (RMB) : is the official currency of the People's Republic of China.

Federal Reserve : The Federal Reserve System is the central banking system of the United States.

Forward guidance : A central bank policy tool intended to guide market expectations regarding the future of policy rates.

Tighten : a decline in the amount of compensation bond holders require to lend to risky borrowers. When spreads tighten, the market is implying that borrowers pose less risk to lenders.

Curve : Refers to the yield curve. Positioning on the yield curve is important to investors, especially during non-parallel shifts.

Monetary policy : Actions of a central bank or other regulatory committee that determine the size and rate of growth of the money supply, which in turn affects interest rates.

Inflation : Characterized by rising price levels.