Market insight: Emerging markets are the new safe havens

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Published: August 28 2007 16:58 | Last updated: August 28 2007 16:58

The world is turning upside down. Or so it might seem to some trying to cope with subprime woes, leveraged structured credit blow-ups, stutters in the commercial paper market and holders of illiquid AAA debt facing 20 per cent losses.

To the emerging debt investor of ten years ago, however, it all looks quite familiar, if from a distance and in a different context.

The ingredients are an underlying credit problem, a largely homogenous base of investors not fully aware of the credit risk when they bought and who try to rush for the exit all at the same time, and a high degree of leverage to exacerbate the rush and create contagion as “good” assets are sold to meet margin calls and cover losses on “bad” assets. Oh, and there were all along some people to say I told you so, and that the whole thing was very predictable given the copious quantities of greed and leverage applied.

Risk tends to be seen by many as binary: once it is deemed non-risky, risk is simply ignored. However, everything is risky. Hence my definition of an emerging market: all countries are risky; the emerging ones are those where this is priced in. People also talk of US Treasury yields as the risk free rates, which translated another way means that US Treasury risk is priced at zero, which it clearly is not (it has plenty of dollar, yield curve and mark-to market risks).

The riskiest high yield carry trade currencies are not those in emerging markets like Turkey or Brazil, but the developed market ones like Iceland and New Zealand – in part because investors are complacent, creating a larger imbalance than possible for an emerging market.

This lack of perception of risk in the Group of Seven leading nations today is different to the emerging markets of old, where risk may have been mispriced but was never priced near zero. Walter Wriston, the late former head of Citigroup, did say “a country does not go bankrupt”, but for the most part nobody thought or thinks that buying emerging debt was risk free.

But then again the possibility of a subprime blow-up was flagged early last year as a risk to global markets. There are also many who have long understood that “long short” hedge funds and structures are dangerous. In extreme situations, the “hedge” often moves the “wrong” way. And excessive leverage can be dangerous whatever the underlying credit risk. So the fact that good credits can be infected by bad – financial contagion – should not be a surprise.

It was the leverage in the market and the homogeneity of the investor base, plus the vulnerability of countries to external shock, that encouraged the emerging market contagion of the past. Today the investor base is much more diverse, institutional, long only, unlevered, and significantly underweight with a buy-on-dip mentality.

The countries themselves are much less vulnerable to external shocks, often with better debt ratios than developed countries, stronger reserves, low inflation and strong current account and fiscal surpluses. If central banks’ main risk is too big a concentration in US assets (including US Treasuries), then non-G7 sovereign debt is often a better risk reducer than other G7 sovereign debt. So emerging debt is the new safe haven. We only hope that there are enough people who do not believe me and sell emerging assets anyway, allowing us to buy paper more cheaply.

Another echo of emerging debt is that crisis can evaporate fairly quickly. As crisis mounts so myopia and fear take over. But hedge fund and investment bank losses may not impact underlying economic activity much, so long as there is a reduction in uncertainty over where and how large the subprime losses are.

This information problem may be resolved much faster than feared, possibly by banks volunteering full transparency of their assets and losses. Likewise the spill-over to emerging markets may reverse suddenly with or without early resolution of the G7's problems, starting with emerging currencies which would arguably rally more the worse the crisis as the dollar weakens.