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EMERGING MARKETS: THE FEAR, THE FACTS AND THE FUTURE

Following years of net inflows, portfolio capital began to look for a way out of emerging markets in 2015. Investors are concerned about China's difficult economic transition, slowing growth, low productivity, rising debt, sour political and geopolitical headlines, weak consumer demand, and the prospect of global interest rate normalization. Many are questioning the strategic role that emerging markets play in their portfolios and even those staying for the long haul recognize that these economies face an important crossroads. In this paper we consider data on financial stability and growth and consumption to describe how the emerging markets got to this crossroads, which road they need to take to reach the next stage of development—and what it all means for investors.

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AT A GLANCE

The Fear

- On debt: Measures of financial stability in EMs have worsened since 2007
- On growth: New data suggest the much-vaunted "rise of the emerging middle class" was over-hyped

The Facts

- In Asia: Manufacturing economies generally look financially robust, but incomes remain low and savings high
- In Latin America: Incomes and consumption have risen in commodity economies, but they now look financially fragile
- In Emerging Europe: Good recovery from 2009-11 debt crisis is paired with near-developed world incomes and savings rates

Country Snapshot

Argentina ⬇	**Peru** ⬆
South Africa ⬇	**Korea** ⬆
Nigeria ⬇	**Hong Kong** ⬆
Turkey ⬇	**Singapore** ⬆
Colombia ⬇	**China** ⬆
Mexico ⬇	**Philippines** ⬆
Brazil ⬇	**Hungary** ⬆
Malaysia ⬇	**India** ⬆

The Future: Implications For Investors

- Many EMs remain strong but the undifferentiated "beta" appears to be over
- There is huge variety that can be exploited with active management
- Long-term themes for capital allocation include:
  - Political change, e.g. in Argentina and Brazil
  - Building manufacturing in Latin America
  - Social reforms to turn Asia's fiscal and current-account strengths into supports for consumption
  - Ongoing convergence in Europe

Source: Neuberger Berman Country Credit Model (CCM).

THE FEAR

Not so long ago, in the teeth of the 2007-09 financial crisis, emerging markets were the saviours of a stricken world. After growing at four-times the pace of the highly-indebted developed world since the mid-1990s, they had the fiscal buffers to forge their own way, building their cities and realising the promise of vast populations poised on the threshold of the middle class.

Less than five years later, growth has slowed dramatically. A rout in emerging market currencies is coinciding with a tightening of financial conditions, reflected in stock market sell-offs and widening credit spreads—all against a backdrop of rising political and geopolitical risk. A decade of declining government leverage was arrested in 2007 and, according to the Institute of International Finance (IIF), net capital flows to emerging markets turned negative in 2015 for the first time in almost 30 years.

Sceptical voices have long argued that the emerging world owed its "catch-up growth" to a mix of China's expansion and low global interest rates, which led to an unsustainable run-up in commodity prices and a flood of capital. As those trends reverse, the resulting glut of often questionable investments lies exposed.

Moreover, while the end of the commodity supercycle is broadly accepted as a consequence of the transition to more consumption-led growth, recent analyses of income distribution suggest that the emerging world's middle class may not be growing fast enough to smooth that transition.

With this background in mind we have looked at two sets of data—on financial stability and productivity and consumption—to describe where emerging markets are today and where they need to go next. We believe the data suggest three things for investors to remember amid the gloomy headlines.

The first is to **keep things in perspective.** Yes, measures of financial stability have deteriorated since 2007, but they remain substantially better than in the late-1990s, and better than the developed world's today. Similarly, while we may not have seen the middle-class expansion that we hoped for 10-15 years ago, more than 600 million people have lifted themselves out of poverty this century, crossing significant income and consumption thresholds.

The second is that **one metric rarely tells the whole story of a country or region.** News headlines like to zero-in—on current accounts one day, fiscal balances or corporate leverage the next. But what do current account balances tell us without reference to reserves? How does the flow of debt relate to the stock? Is it significant that the places with higher debt levels are often the ones with higher incomes and consumption?

Finally, **emerging markets are far from homogeneous.** Globalization has caused convergence between emerging and global financial markets, and we find substantial regional themes in our data. But they also reveal extreme differences between regions and countries. Investors can take note of these idiosyncrasies not only in seeking to enhance return potential, but also in seeking to allocate capital efficiently to facilitate the next phase of "catch-up" convergence with the developed world.

THE FACTS… ON FINANCIAL STABILITY

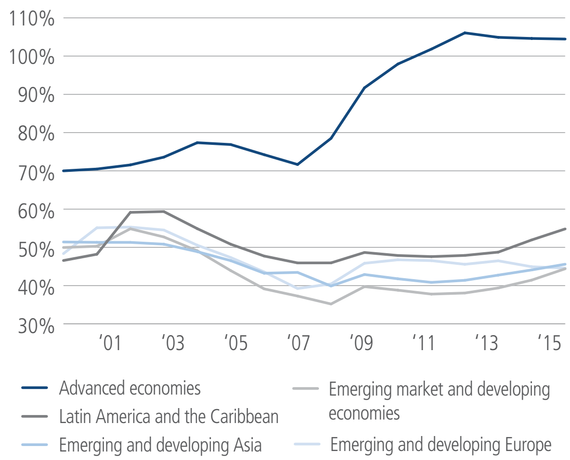
- Debt and current account metrics have weakened since 2007, cushioned by higher levels of reserves and sovereign wealth
- In general, commodity-based Latin American and African economies are faring worst (Venezuela, Angola)
- Manufacturing-based Asian and European economies are faring best (The Philippines, Hungary)

The Asia crisis and Russian default of the late-1990s led to meaningful policy changes in the emerging world. Combined with a new era of growth, the results were declining levels of sovereign leverage (figure 1) and growing foreign exchange reserves and current account surpluses. More recent trends have not been so impressive, however.

A country's debt burden tells us something about its ability to respond fiscally to economic shocks, and its flow of debt signals its commitment to keeping that debt burden under control. Should we therefore be concerned that debt fundamentals have deteriorated since 2007? A number of emerging economies entered the 2007-09 financial crisis with fiscal surpluses, but by 2015 slowing growth and falling tax revenues had left hardly any with positive balances. The stock of debt has also grown since 2007. On the other hand, the U.S.'s government debt-to-GDP ratio is over 100%, Japan's well over 200% and Germany's is close to 80%. Today, among our sample of emerging countries, only Egypt, Ukraine and Singapore exceed this level—two revolution-roiled states and one quasi-developed.[1]

FIGURE 1. DEBT RATIOS IN THE EMERGING WORLD REMAIN LOW, BUT ARE RISING

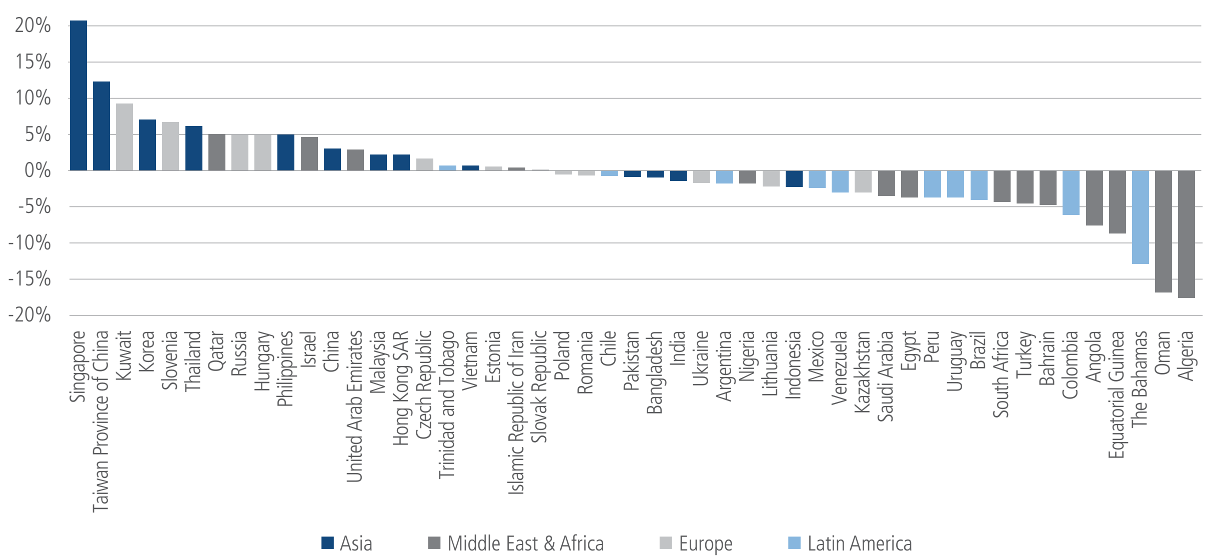
Gross Government Debt as a Percentage of GDP



Source: IMF. Estimates start after 2014.

FIGURE 2. THE COMMODITIES CURSE: CURRENT ACCOUNT DEFICITS CONCENTRATED IN AFRICA, MIDDLE EAST & LATIN AMERICA

Current Account Balances as a Percentage of GDP, 2015 Estimates



Source: IMF. Data as of October 2015.

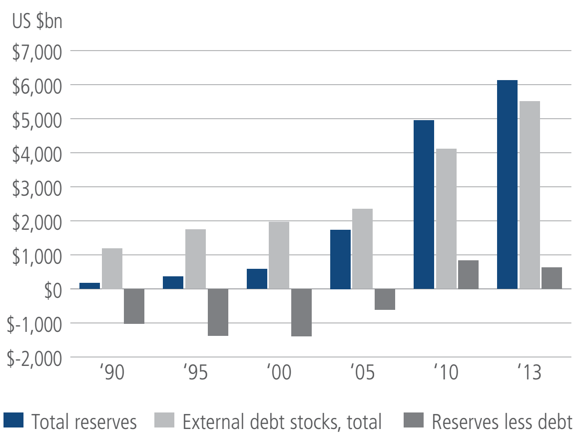
[1]For the purposes of this paper we compare these data, where available, for a sample of 50 emerging countries. Our universe was selected by taking the top-40, in terms of 2015 GDP, from the IMF's database of emerging market and developing economies, supplemented by the 10 with the highest GDP-per-capita that were not already represented in the first sample of 40.

A similar deterioration can be seen in emerging countries' current accounts, which tell us how much external financing they need in any given year. A surplus with the developed world in 2006 is fast becoming a deficit, largely driven by China's weakening demand for commodities. The economies in our sample that are most dependent on extractive exports are Algeria, Nigeria, Qatar, Saudi Arabia, Venezuela, Chile and Peru, all of which fare poorly when it comes to current accounts (figure 2).

The exception to the generally poor recent news is that on reserves: since 2007, foreign exchange reserves and longer-term sovereign wealth has continued to grow (figure 3). Recent current-account deterioration shows why efforts to build these reserves since the crises of the late-1990s were so important: the IIF estimates that emerging countries spent more than $340 billion of their reserves in 2015 to counteract capital outflows—half of the late-1990s total but barely 5% today.

FIGURE 3. RECENT YEARS HAVE SEEN A HUGE ACCUMULATION OF RESERVES…

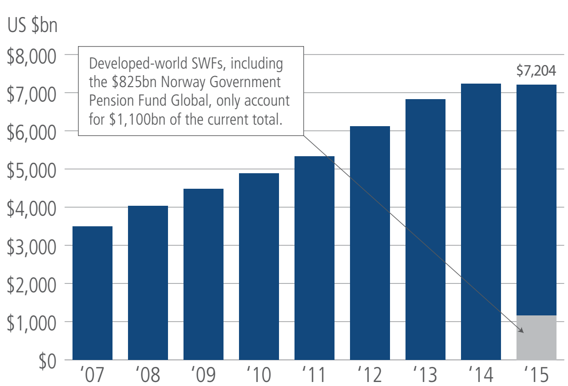
Total Reserves and External Debt Stocks, All Developing Countries



Source: World Bank. Data as at October 2015. The All Developing Countries group includes low- and middle-income economies in which 2013 GNI per capita was $12,745 per annum or less.

… AND SOVEREIGN WEALTH

Total Assets of Sovereign Wealth Funds, Globally



Source: Sovereign Wealth Fund Institute. Data as of December 2015.

> "Sovereign fundamentals in emerging markets remain in relatively good shape."

This is a vital point: a current account deficit is only a problem if a large stock of external debt is close to maturity and in need of refinancing and there are no foreign exchange reserves to turn to instead of external debt markets. By the same token, a temporary deterioration in the fiscal balance is much less worrying if the stock of debt is low; and a positive fiscal balance can signal a willingness to reduce a high debt stock. This reminds us that it is difficult to judge a country by looking at any one indicator of financial strength in isolation.

So, for example, Russia and Chile run fiscal deficits but have low debt burdens while Hong Kong and Singapore compensate for high debt burdens with fiscal surpluses—their debt issuance has more to do with maintaining liquid bond markets than with financing government spending. By contrast, India, Argentina, Malaysia, Mexico, Brazil and South Africa run fiscal deficits with already large debt stocks. When it comes to current accounts, whereas Latin America and Africa have seen a lot of deterioration, it is notable that Brazil, South Africa and Angola have all improved their short term debt-to-reserves ratios since 2007.

On the whole, sovereign fundamentals in emerging markets remain in relatively good shape, especially compared with the late-1990s and with developed markets. But some are undoubtedly in better shape than others. What do our indicators tell us about the relative position of countries *within* the emerging world?

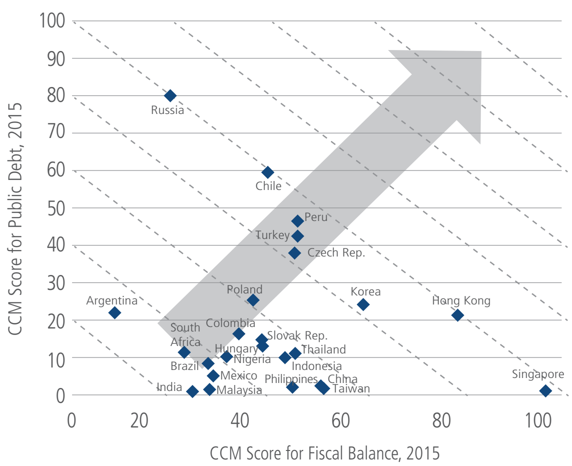
To answer that question we will turn to the internally-developed and proprietary Country Credit Model (CCM) that Neuberger Berman's emerging markets debt team uses to rank countries on their financial health and stability. Forty percent of the CCM is based on environmental, social and governance (ESG) measures that we will return to later. First, we will focus on the 10 macroeconomic measures of financial stability, some of which indicate the capacity to respond to or survive shocks to that external financing (such as the government debt burden, the fiscal balance and the short-term debt-to-reserves ratio); and some of which indicate the cost and availability of external financing (such as the current account balance and the external debt burden).

As we said in our introduction, two points stand out from the CCM scores. The first is that **there are extremes of positioning:** India (poor) and Hong Kong (good) are at opposite poles when it comes to government debt and the fiscal balance while Turkey (poor) and the Philippines (good) look completely different in terms of exposure to potential spikes in the cost of external financing via current account deficits. But on the other hand, Turkey looks relatively healthy on government debt measures and India is well-positioned with regard to its external financing needs. That exemplifies our second point: **many countries score poorly in one area of financial stability but better in another, which acts as an offset.**

FIGURE 4. COMPARING THE STOCK & FLOW OF DEBT, CURRENT ACCOUNTS & RESERVES

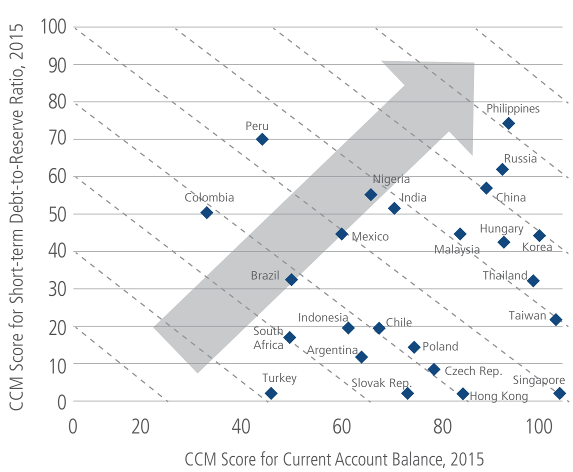
CCM Scores for Public Debt as a Percentage of Revenues, Fiscal Balance as a Percentage of GDP

Countries nearest the top-right corner are best-positioned



CCM Scores for Short-Term Debt as a Percentage of Reserves, Current Account Balance as a Percentage of GDP

Countries nearest the top-right corner are best-positioned



Source: Neuberger Berman. Data as of October 2015. The emerging markets debt team deploys a Country Credit Model (CCM) to rank emerging countries. These illustrations show the CCM scores for the fiscal balance and public debt, and for the current account balance and short term debt-to-reserve ratio, respectively.

Figure 4 should help to visualize this concept for the two aspects of financial strength we have been discussing so far. It shows the CCM scores for the flow and stock of debt on one plot, and for current account and the short term debt-to-reserves ratio on the other. In general countries that are further to the upper right in either plot have stronger overall financial stability based on the two data points. We can see the relatively healthy positions on fiscal flexibility for Russia, Chile, Hong Kong and Singapore; and the surprisingly strong positions for Peru, Nigeria and Malaysia, for example, when it comes to exposure to potential spikes in the cost of external financing.

Turning to the overall results from our CCM, at the thematic and regional levels we confirm the pattern of high scores for commodities-light emerging European and Asian countries, with commodities-heavy Latin America, the Middle East and Africa providing the ballast. Since 2007, Hungary and the Philippines are the most improved while Venezuela and Angola are the most deteriorated. India shows evidence of its recent improvement since 2012.[2]

FINANCIAL STABILITY: THE HIGHLIGHTS

- Most improved since 2007: Hungary, the Philippines
- Most deteriorated: Venezuela, Angola
- Most improved since 2012: India
- Most deteriorated: Iraq

Major economies' progress since 2012:

Hungary ▲▲▲	**Turkey** ▲	**South Africa** ▼
India ▲▲▲	**China** ▼	**Brazil** ▼▼▼
Philippines ▲▲	**Indonesia** ▼	**Colombia** ▼▼▼
Poland ▲▲	**Mexico** ▼	**Russia** ▼▼▼

- Biggest positive impact from ESG score: Singapore, Hong Kong
- Biggest negative impact: Algeria, Nigeria

Source: Neuberger Berman CCM.

[2]Compare recent work by Liliana Rojas-Suarez of the Centre for Global Development, which uses similar measures to assess emerging countries' capacity to withstand and respond to adverse external shocks. In Rojas-Suarez's rankings for 2014, the three best-positioned countries were the Philippines, Korea and China and the three worst-positioned were Argentina, Hungary and Latvia. The most improved since 2007 were the Philippines, Colombia and a number from emerging Europe; the most deteriorated were Argentina, Brazil, Chile, India, Indonesia and Malaysia. Regionally, Latin America stood out as most deteriorated, with four out of the six countries in her sample "less resilient" than in 2007. Liliana Rojas-Suarez, "Emerging Market Resilience to External Shocks: Today versus Pre-Global Crisis", Centre for Global Development Essay (February 2015).

Next, we can consider the impact that our 15 ESG measures have on these scores. These cover things such as energy intensity, ease of doing business, political stability and trade openness. The most positive impacts are seen in emerging Europe, Singapore, Hong Kong, Uruguay and Chile, and the most negative in Nigeria, Russia, China, the Philippines and India. Just as various macroeconomic indicators offset or amplify others, so high ESG scores can support weaker macro scores, reflecting the fact that countries with more developed institutions can run their finances more like developed economies. We should not be too concerned about Singapore's large debt burden or Hong Kong's deteriorating fiscal balance, for example, but we should recognize that financial health in China and the Philippines rests on still-developing foundations.

"We continue to expect substantial improvement from India."

Finally, what does our CCM suggest for 2016? It continues to expect substantial improvement from India, but puts Venezuela, Argentina and Egypt among those likely to deteriorate. It anticipates better news for Ukraine, Russia, Brazil, South Africa and Turkey, but not for Hungary, Poland or the Czech Republic. This reflects expectations for a certain amount of mean reversion from this point—but not enough to change our regional rankings for 2016, which still put Asia well ahead and the commodity-exporting regions behind.

THE FACTS… ON GROWTH, PRODUCTIVITY AND THE "EMERGING CONSUMER"

- Millions have moved out of poverty but projections of a "global middle class" were far too optimistic
- There is new prosperity in China, South America and Eastern Europe
- The middle class has barely expanded in India, Southeast Asia or Africa
- There is some overlap between the strongest economies for financial-stability and the weakest for income levels, and vice versa

If the improvement in financial stability since the late-1990s was one pillar of the new era of emerging markets investing, then the "rise of the global middle class" was certainly the second. It has enjoyed great success so far this century: stocks with the highest proportion of revenues coming from the emerging world—regardless of whether or not those stocks are listed or domiciled there—have far outperformed both the emerging- and developed-market indices. They have continued to do so even during the recent years in which emerging markets have run out of steam.

But this is far more than an investment theme—for much of the developing world, exemplified by China's program of transition, it is long-term policy. In the aftermath of the financial crisis, it was common to see the replacement of the flagging U.S. consumer with the "emerging consumer" as an important ingredient in global re-balancing. In this section of our paper, we look for evidence of this happening.

When Coca-Cola announced its "2020 Vision" strategy in 2009, projecting that the next decade would see a billion new middle-class consumers entering the economy, it echoed an increasingly mainstream story coming out of investment banks, official institutions, management consultancies and think tanks.

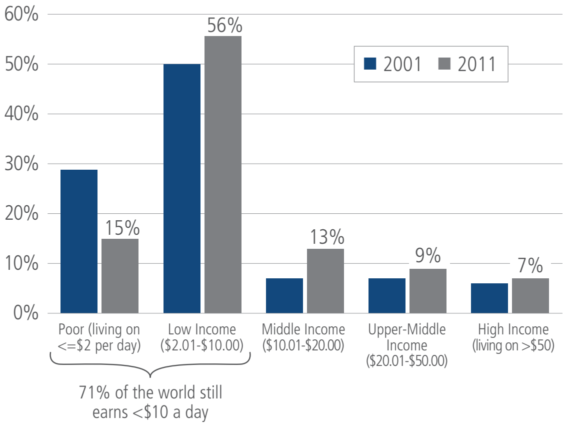
One of the more widely-read notes on the subject came from Goldman Sachs in 2008, by which time the "expanding middle" was "already a fact". It defined this class as earning between $6,000 and $30,000 per year in 2005 PPP terms, or $16-$82 per day, the "level at which rates of discretionary spending seem to pick up sharply". Like Coca-Cola, it estimated an extra billion would join the middle class by 2020. By 2030, 30% of the global population would be middle-class, starting with China and spreading to India, but encompassing the entire emerging world. Latin America and emerging Europe were in the lead but their pace of growth would peak by 2010 and Asia would take over.[3]

Projections like these came with caveats, and indeed when our picture was updated in 2015 by the Pew Research Center, using 2011 PPP for the first time, it looked rather different. For example, this study estimated that 1.7 billion people were earning between $10 and $100 per day in 2011, whereas Goldman Sachs, using its narrower income range of $16-$82 per day, had projected a middle class numbering two billion by then. Taking China specifically, Goldman Sachs estimated that there would be around 600 million middle-class by 2011; the Pew Research Center suggests that there were only 300 million earning at least $10 per day, with no upper limit.

[3]Dominic Wilson and Raluca Dragusanu, "The Expanding Middle: The Exploding World Middle Class and Falling Global Inequality", Goldman Sachs Global Economics Paper No. 170 (July 2008). Similar sentiments and projections can be seen in Homi Kharas, "The Emerging Middle Class in Developing Countries", OECD Development Centre Working Paper No. 285 (January 2010); and Richard Dobbs, Jaana Remes, James Manyika, Charles Roxburgh, Sven Smit and Fabian Schaer, "Urban World: Cities and the Rise of the Consuming Class", McKinsey Global Institute (June 2012).

FIGURE 5. THE WORLD IS MUCH LESS POOR THAN IN 2001, BUT STILL NOT WELL-OFF

Income-Level Distribution of Global Population, by Percentage and by Millions of People



Source: Pew Research Center. Report published August 2015. Analysis of data from the World Bank PovcalNet database and Luxembourg Income Study database. People are grouped by the daily per-capita income of their family or the consumption of their family, depending on how the source data for each country are collected.

On the face of it, the new data seems to challenge the entire "emerging middle" convergence thesis. In fact, the story is more interesting than that. First of all, the data is not all bad news. Between 2001 and 2011 almost 670 million people escaped poverty. The middle-income group itself almost doubled with the addition of some 400 million people: many countries now have per capita GDP and median income above the important $3,000 and $6,000 thresholds at which people start to buy more meat, snack foods and the refrigerators to store them, and mobile phones and other high-end durables, respectively.

Moreover, there has been substantial regional divergence—prosperity has risen in line with earlier expectations in China, South America and Eastern Europe, whereas the middle class has barely expanded in India and Southeast Asia, Africa, or Central America.

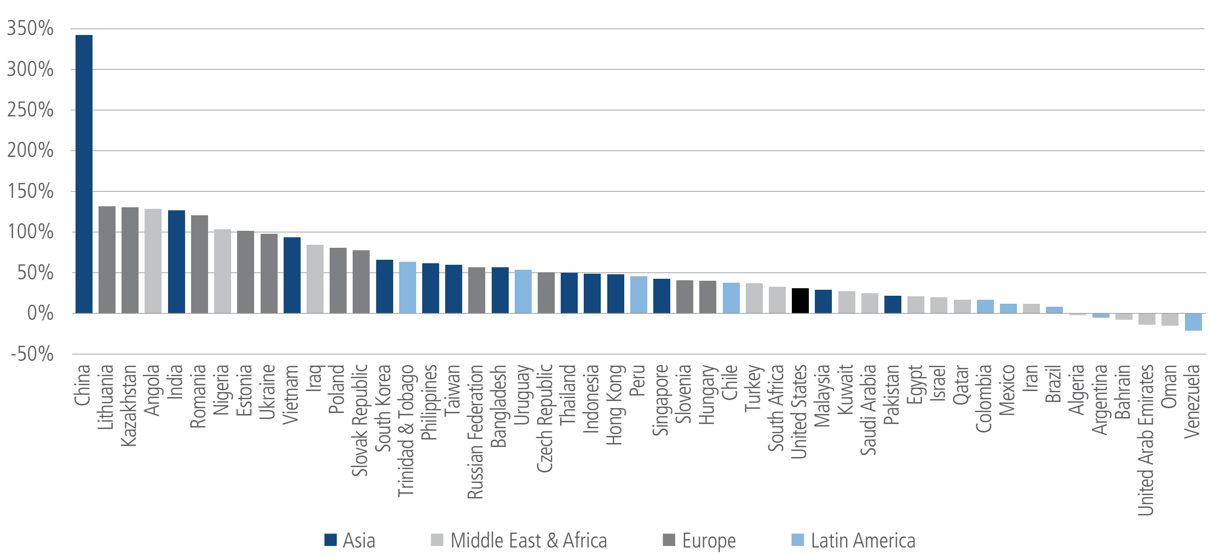
> "Why hasn't economic growth fed into growing incomes in the same way it has fed into tumbling sovereign debt ratios?"

We need to explain why the extraordinary pace of economic growth in the emerging world has not fed into growing incomes as expected, in the same way that it clearly has fed into tumbling sovereign debt ratios. But we should also look into the relationship between the data about income distribution and the data on sovereign financial stability.

We can do this by considering trends in productivity growth. Improving productivity is the source of the long-term growth, in excess of population growth, that will keep debt sustainable; and as that implies, it is also the source of the quality wages that will support the transition to middle-class consumption.

FIGURE 6. ASIA HAS BEEN OUTPERFORMING LATIN AMERICA ON LABOUR PRODUCTIVITY GROWTH

Change in Labour Productivity Per Person Employed, in 2014 US$, 1997 to 2015



Source: The Conference Board Total Economy Database 2015.

The picture is not immediately encouraging. Labour productivity in the emerging world is growing at half the rate that it did during the 2000s even though, outside of the Middle East and the quasi-developed Asian economies, it is still just 19% of the U.S. level, on average.[4] Data on total factor productivity (TFP) is even more discouraging: the growth rate is negative in China, Brazil, Mexico and Russia, and only marginally positive in India. This may be because rising corporate leverage has been driven more by low global interest rates than by good investment opportunities; or due to a lack of demand from both the developed economies and local consumers; or a stalling of the economic, social and regulatory reforms necessary for the next step up in efficiency; or a combination of all three.

Again, however, the real interest lies in the regional variation in productivity growth, shown in figure 6. Here we see a split familiar from the data on financial stability and income distribution: manufacturing Asia dominates (some of the Asian economies at the lower end of the productivity-growth scale, such as Hong Kong and Singapore, already enjoy high levels of productivity); emerging Europe presses on from an already higher base; and commodities-heavy Latin America falls down the list while Indonesia and Malaysia bring up the rear within developing Asia. And recall that during this period the price for soybeans doubled, copper appreciated fourfold and oil fivefold.

THE FUTURE

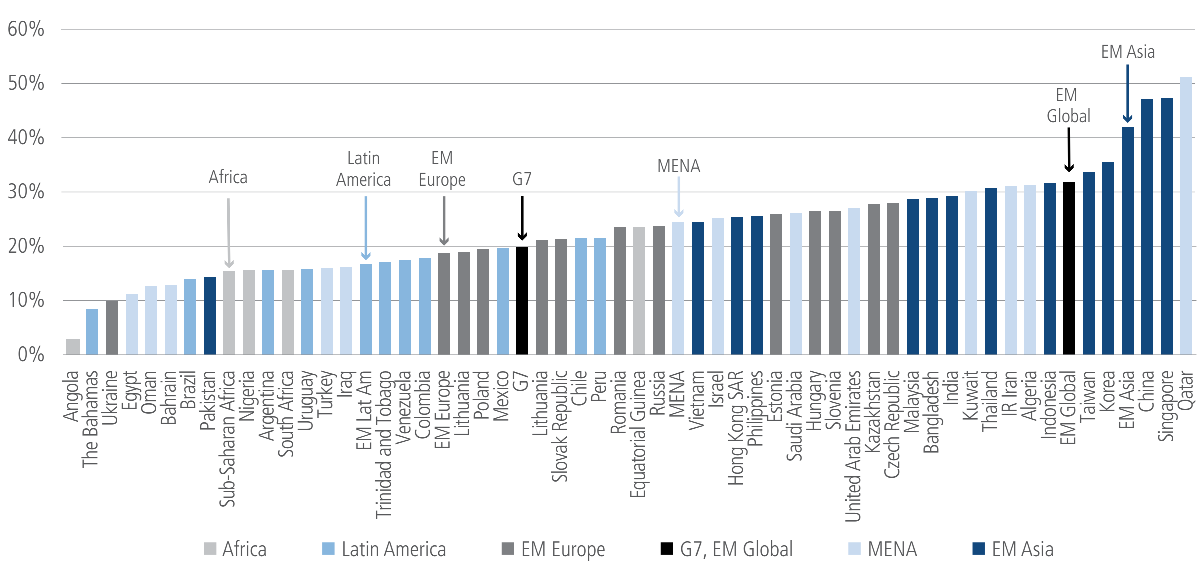
- The commodity boom improved incomes but not productivity or fiscal strength
- The manufacturing boom improved productivity and fiscal strength but not incomes
- A good balance can already be seen in emerging Europe, Peru, Korea, Hong Kong and Singapore
- Argentina, Brazil and Mexico could be about to turn their fortunes around

In very simplified terms, the pattern we see is a split between economies that have enjoyed a 15-year windfall from rising commodity prices, driven by China's investment spending, and those without natural resource endowments that have instead focused on manufacturing to meet demand from both China and the developed world.

The former, through booms in the commodities and service sectors and generous social spending, enjoyed early gains in productivity, personal incomes and consumer spending—but incurred higher debt burdens and current-account cyclicality in doing so, and may now be discovering the limits of the productivity and wage growth associated with their chosen sectors.[5]

FIGURE 7. ASIA IS A REGION OF SAVERS, LATIN AMERICA A REGION OF CONSUMERS

Gross Savings as a Percentage of GDP, 2015 Estimates



Source: IMF. Data as of October 2015.

[4]The Conference Board, Productivity Brief 2015: Global Productivity Growth Stuck in the Slow Lane with No Signs of Recovery in Sight (May 2015). The Conference Board is the source for this paper's data on productivity. See also Chapter 3 in IMF World Economic Outlook: Uneven Growth: Short- and Long-Term Factors (April 2015).

[5]See the discussion of "Commodity Booms and Public Investment" in IMF World Economic Outlook: Adjusting to Lower Commodity Prices (October 2015).

The latter have enjoyed slower economic, productivity and income growth during the commodity boom years due to high import costs, but appear to have developed more sustainably because this encouraged greater fiscal discipline and resulted in economies that are more diverse and less sensitive to global cycles.

More evidence of this split can be seen when we look at savings rates, which show Latin America and Africa saving less even than the G7 countries (figure 7). But the days of high disposable income in the commodities economies may be over: recall that the Pew Research Center's picture of global income dispersion is based on 2011 PPP calculations and that, since then, the currencies of commodity exporters have plummeted, eating into their citizens' purchasing power.

We know what the next chapter of development in the emerging world needs to look like, because we have seen it happen before in places such as Korea and Taiwan, where productivity gains have led to both high personal incomes and sustainable levels of debt. What does the rest of the emerging world need to do to get there?

If we accept that China's economy is changing, then the commodity exporters need to reposition thoroughly. The good news is that the correction in foreign exchange rates provides an excellent base from which to begin work on export-led industrialization, while a combination of hardship and corruption revelations is inciting the aspirant middle class to demand judicial independence and more pro-business, fiscally-disciplined regimes. Argentina's recent election and progress with its creditors, dwindling support for Venezuela's socialists, and ongoing corruption investigations in Brazil are the headline examples.

> "The data favours Peru, Korea, Hong Kong, Singapore, the Philippines, China, Hungary and India."

It would be tempting to see the move to a low-commodity price environment as beneficial for Asia's manufacturers, but there is still a lot of work to be done to move from heavy industry to higher-value manufacturing to help close the development gap with Latin America and emerging Europe. Moreover, some economists argue that inflows of capital up until 2013 have made Asia's exchange rates overshoot, pulling resources away from tradable sectors and towards services. Getting back on the road to a more productivity-friendly balance between heavy industry, high-value manufacturing and services may require further declines in exchange rates, as well as some short-term pressure on incomes.

Again, there is good news: the models for this transition are themselves Asian, and the most important country, China, appears to be managing it well in its long-term project to become a diverse, almost self-supporting economy. Similarly campaigns such as 'Make in India' show that governments understand that an emerging economy cannot thrive on IT outsourcing alone.

There is a further need to support income growth and consumption by building social-security and medical-insurance systems in Asia. Many of these economies enjoy the fiscal flexibility to provide these systems, and their savings would be more productively-employed in private social and medical insurance than they are now. Again, China and India are making progress here, but it is a long-term project.

Summing everything up by comparing the best and worst-positioned countries based on our findings for solvency, external financing needs and productivity gains, the data seem to favour Peru, Korea, Hong Kong, Singapore, the Philippines, China and Hungary, with India also faring pretty well; while riskier countries might include Argentina, Brazil, South Africa, Nigeria, Turkey, Malaysia and Colombia, with Mexico causing some concern.

Of course, that doesn't necessarily translate into attractive investment opportunities: for a start, these fundamental metrics do not take account of current valuations, and especially valuations in relation to whether fundamental metrics are improving or further deteriorating from a poor base. Countries with poor metrics but a possible turnaround story often present the highest total-return potential thanks to valuations.

Indeed, it's worth remembering that, while these snapshots of where countries are today and where they have come from can be helpful in evaluating investment opportunities, they may miss those economies passing through important inflexions. Brazil's currency and current-account adjustments may be an example, or Argentina's new administration. Mexico's industrial mix fits the model we describe but none of that currently comes through in the form of a current account or fiscal surplus, low government debt, or fast-growing productivity. However, that may have something to do with its high exposure to the US recession of 2007–09. As that headwind eases, Mexico's manufacturers will look very competitive relative to both US domestic capacity and even China, as supply chains continue their localisation trend.

IMPLICATIONS FOR INVESTORS

At the start of this paper we wanted to address some of the current fears around emerging markets by reminding investors of **the huge progress most have made since the 1990s, the (increasing) variety and complexity they represent, and the importance of looking past headline data**

points to see the full picture. Having done that, we should finish by drawing out the most important implications for investors. We would identify five points that we believe investors should keep in mind:

1. It is important to be tactical with your allocations _within_ emerging markets, but strategic in your allocation _to_ emerging markets.

Many developed world investors have begun to see their emerging markets investments as strategic and steadily-growing as they globalize their portfolios, and yet there is still a tendency to regard them as an undifferentiated "satellite" allocation that gets dialled up or down depending on global risk appetite. There is no doubt that investors are paid an "emerging markets premium"—but there is equally no doubt that some emerging markets are less fundamentally risky than many developed markets. Few investors think of their European or US allocation as tactical risk proxies, and as they develop it becomes increasingly untenable in emerging markets, too.

2. Active management is important because there is no such thing as "the emerging world".

Just about the only thing that these parts of the world have in common is that they are changing, economically and socially, at a more marked rate than Europe or the U.S. That is why we call it the "developing" world. We view passive investing as backward looking. We believe active management is better suited to participate in economic realities that are identified: the turn in the commodities story that we identify in the data is only the most obvious example of how the past is such a poor guide to the future in emerging markets. As we acknowledge, our snapshot of current strengths and weaknesses in these markets may paint an overly negative picture of potential turnaround candidates such as Argentina or Mexico.

3. Beware of analytical "short cuts" and headline data points.

Passive management can certainly fail to recognize the rich variety of these markets, but even active managers can be guilty of using isolated "headline" data points as a shortcut to real understanding. As we have seen, emerging economies with more developed government, central bank and market institutions, and offsetting reserves or fiscal policies, can afford to run higher debt and current account deficits just as developed economies do—but in the short-term they can still be punished for doing so by myopic capital that sees the emerging world as a simple risk-proxy bloc and ends up missing long-term value opportunities or overpaying for unsustainable growth.

This variety gets multiplied at the individual-company level. Just because a business is listed and domiciled in a certain country, it does not necessarily follow that its end demand comes from that country; and even when it does, performance will owe at least as much to the quality of its management and the outlook for its sector as it does to that listing. Top-down views are important—country risk can certainly overwhelm fundamentals at times—but real mis-valuation opportunities are often best identified with a combination of top-down and bottom-up analysis.

4. Today's problems are tomorrow's investment themes.

From our snapshot of the data it would be easy to identify Asia and Europe as the most compelling investment opportunities, and Latin America and Africa as the least, but that would be simplistic. As we have seen, not all fiscally-robust countries have done enough to develop genuine domestic consumer demand, while others have stimulated consumption on the back of commodities-related revenues or excessive debt. Only a few have achieved a good balance and many of these are European or quasi-developed.

That means the next phase of global development will require capital to support the building-out of a real manufacturing base in Latin America (to generate the productivity improvements that will support current levels of consumption); and of social security and consumer-finance systems across Asia (to create a local consumer base that will support current levels of production in a lower-growth, lower-trade world). These are opportunities for private companies listed in both emerging and developed markets, of course, but they are

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also opportunities for sovereign debt investors who can look beyond headline debt metrics and appreciate pro-growth expenditure on, say, pensions and health insurance in China or infrastructure development in Mexico and India.

5. Non-financial factors tend to make a big difference in emerging economies.

This is one reason why ESG factors play such an important role in our approach to emerging debt, in particular. When the focus moves from looking for the most financially-robust countries to looking for the smartest developers, governance and efficiency come to the fore: spending money wisely (as opposed to not spending it at all) requires low levels of corruption and high levels of government effectiveness, human development and ease of doing business, to take only the most obvious examples. Ultimately, emerging-markets investors are trying to deploy their capital to create wealth and consumption growth that is not based on unsustainable levels of debt, de-industrialisation, social inequality or environmental degradation. ESG indicators play a key role in ensuring the proper granularity and long-termism of investors' views, and the avoidance of any short-term focus on headline data points.

In summary, the twin pillars of emerging market investment 10-15 years ago—greater financial stability and the emerging consumer—remain in place today. We believe a genuinely strategic, active, adaptive and research-based approach is the optimal approach for identifying which countries and businesses are working to achieve the ideal combination of financial stability, sustainability and flexibility to support productivity growth. Anything else risks being part of the problem of global capital misallocation, at the mercy of one short-term market trend after another.

ABOUT THE AUTHORS

Conrad A. Saldanha, CFA, Managing Director, joined the firm in 2008. Conrad is a Portfolio Manager for the Global Equity team and is responsible for Emerging Market equities. Prior to joining the firm, he held several positions at GE Asset Management, Inc., most recently, vice president and co-portfolio manager on the Global Emerging Markets product, as well as the portfolio manager for the Indian Equity strategy. Previous positions include vice president and portfolio manager for International and European equities, analyst for International, European and Emerging equities. Conrad began his career at GE Capital's Financial Management Program. He earned a BCom from St. Xavier's College, Calcutta, an MBA from Virginia Polytechnic Institute and has also been awarded the Chartered Financial Analyst designation.

Rob Drijkoningen, Managing Director, joined the firm in 2013. Rob is a Portfolio Manager and Co-Head of the Emerging Markets Debt team. Rob joined the firm after working at ING Investment Management for almost 18 years, most recently as the global co-head of the Emerging Markets Debt team responsible for managing over $16 billion in assets. Rob began his career at ING Investment Management as a senior investment manager for global fixed income. In January of 1997, he became global head of the Emerging Markets Debt team and in 2004 was named global head of the Emerging Markets Debt and High Yield teams. From 2007 through 2009, Rob created and led ING Investment Management's Multi-Asset Group in Europe, managing mandates across asset classes including fixed income, equities, real estate and commodities. In 2009, he was named global head of emerging markets, with responsibility for both emerging markets equity and debt strategies. Prior to joining ING Investment Management, Rob worked on the sell-side at Nomura and Goldman Sachs. Rob earned his Macro-Economics degree from Erasmus University in Rotterdam and has authored numerous articles on emerging markets debt subjects. He is DSI qualified.

The Neuberger Berman Emerging Markets Debt team deploys an internally-generated, proprietary Country Credit Model (CCM) to rank emerging countries. Illustrations shown herein reflect the CCM scores for the fiscal balance and public debt, and for the current account balance and short term debt-to-reserve ratio, respectively. Green and red arrows signify a positive or negative progression (improvement/deterioration) since 2012 based on CCM scores.

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