The silver lining for emerging markets

By Lerato Morwe and Mkhululi Duncan Stubbs

In finance, as with much else, the distinction between perception and reality is one without difference. As the developed financial markets attempt tentatively to make the transition from fragile to sound, emerging markets seem to have taken the driving seat.

Our perception is that they have done so with aplomb.

When markets contract, investors keep their money close to home. This stands to reason, since when investing gets risky, it makes sense to bet on a sure thing.

Traditionally, domestic government bonds have been the dominant safe haven for investment. And why not?

In economic terms, the spike in global risk aversion increases investors' home bias and their demand for "safe" assets. Thus, investors in mature economies tend to sell emerging-market holdings and invest in assets like domestic government bonds or gold.

This has a direct and sharply negative impact on capital flows to emerging economies. In the past, investors' "flight to quality" response has often led to drastic withdrawals of equity and bond inflows from emerging markets. In recent months, jitters in financial markets have once again prompted investors to dump emerging-market assets.

It is a phenomenon that is also reflected in emerging-market currencies, which have plummeted over the same period. In an environment of high risk aversion, there is a chance that spillovers to emerging markets may produce a more severe economic slowdown.

In past years, United States Treasury bonds would all but certainly provide the yield that investors were looking for.

In what has been touted as a potentially historic transformation, the incipient ascendancy, in growth-terms, of the emerging economies over the emerged is of such a nature that the World Bank has gone so far as to say that "[d]eveloping countries are not just leading the recovery. Increasingly they are an important source of [global financial] stability".

This of course begs the question as to the reason for the shift. Two such reasons spring to mind:

- Sluggish growth in the global north. While the Euro Area and the US labour and housing markets show limited promise, overall short-term projected growth in emerging economies generally exceeds that of the developed world by several orders of magnitude.
- The macroeconomic response to the stunted growth of the developed world, which is to prolong low interest rates. Low rates diminish risk-aversion, and the consequent interest rate differential makes emerging economies look a great deal more attractive to an investor looking to make a profit.

More specifically, South Africa is expected to continue to benefit from robust capital inflows, through this year and 2012. The local bond market is playing its part, bolstering the capital account by providing substantially better yields than international markets.

What's more, yields are likely to remain at record lows in the US, where the Federal Reserve recently announced that short-term rates would hold steady through the middle of 2013. As long as the substantial differential between South African and US yields subsists, foreign investment in the rand-carry trade looks promising.

And for the reader who dismisses all of this as speculative mumbo-jumbo, the proof of the pudding, on the South African financial landscape, is in the eating:

- in March of this year, retail giant Edcon established its R2 billion domestic medium term note programme on the JSE's Interest Market, issuing R1 billion of senior secured floating rate Notes thus far;
- BNP Paribas has perhaps taken a further step by inward listing an unlimited programme; and
- Goldman Sachs recently broke South African records for foreign inward listings with its record-breaking R1,25 billion in senior unsecured floating rate Notes just a matter of weeks ago.

Significantly, Bowman Gilfillan's debt capital markets team carried the torch on all three transactions.
Thus, though the global financial forecast is cloudy, the silver lining is that large-investor perception seems to be swinging in South Africa's direction.

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