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"Maturity"

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The holiday season is upon us and for many this means spending time with family and friends. At parties and gathering this time of year we naturally find ourselves reminiscing about life's various milestones, both joyous and sad. My favorite stories are those that touch on the follies of youth. The sort of stories that give insight into our character and show how we have since matured. One of my favorite stories of youthful exuberance comes from an uncle who at sixteen with his newly issued driver's license "drove" his VW beetle down a ski hill in Minnesota. While he and the car survived intact, the story reminds us that just because the law deems sixteen-year-olds as responsible enough to operate a motor vehicle doesn't mean it's true. Nonetheless, society pins many rites of passage to a certain age, be it driving at 16, voting at 18, and drinking at 21, rather than based on merit. Despite being told to "act our age" or "act like an adult," I suspect we all know those who despite their age continue to elude maturity. Maturity is gained by experience and learning, not simply the passage of time, and the path to maturity is rarely a straight line.

The global community has its own sort of rites of passage. Labels like "developed", "emerging", and "frontier" are in fact judgments about the maturity of a sovereign nation. Countries must pay their dues, economically and politically, to transition from one category to the next. The precise nature of the requisite criteria remains more than a little ambiguous and seemingly arbitrary. These designations have real consequences as emerging and frontier countries are treated differently than developed countries by the market. While Argentina and Venezuela have failed to demonstrate the behaviors expected of a responsible nation, relegating them to emerging market status, can we really judge Greece or Italy as acting better? These European nations have just been acting irresponsibly for much longer. To add insult to injury, emerging and frontier market nations are often placed under the guardianship of their developed peers through organizations like the International Monetary Fund (IMF) and World Bank.

Like individuals, countries mature at different rates. For instance, China has taken a long time to gain its well-deserved superpower status. Yet, from the standpoint of the markets, it's still viewed as emerging, and therefore risky, requiring it be offered at a discount to investors. Europe, on the other hand, which is in jeopardy of losing its status economically and politically continues to command a large premium by investors. The markets may be mispricing the future potential of many emerging market countries relative to their developed market peers.

An opportunity exists for the discriminating investor dedicated to assessing the relative risks between emerging and developed nations. The rating agencies make judgments of creditworthiness based on traditional macroeconomic variables and geopolitical risks. Their calls are often late and reactionary, however. Market participants are far better at assessing the short-term fluctuations through the market pricing level. Short-term volatility often tends to distort the presence of a long-term opportunity.

Mature or not in the eyes of the global community, the growth prospects in most emerging market countries exceed those in the developed world. Approximately 85% of the world's population live in and 50% of the world's economic activity occurs within the definition of emerging markets. As a group, emerging markets have significant natural resources, favorable population demographics, and rapidly rising living standards. Unlike the often-outdated preconceptions, emerging market countries, by and large, have adopted a market economy, embracing the tenets of economic liberalism. There is arguably more currency flexibility in emerging market countries than there is in Europe under the Euro regime and an investor is just as likely to find an independent central banker in Latin American as in North America. Many of these countries have built large hard currency reserves while average indebtedness is less than their developed market peers. Many also have substantial savings which have been used to finance trade imbalances with the developed world. Domestic institutions to channel savings are developing rapidly, and the depth of local capital markets are expanding. The fear of capital flight is far less of a risk today than in prior cycles.

Emerging markets no longer suffer the collateral damage coming from the developed world's economic cycle. Their current cycles of growth and inflation are increasingly independent of those of the developed world. There is increasingly a north/south axis of trade within emerging countries. Meanwhile, increased trade activity promotes greater levels of per capita income leading to an emerging middle class fueling domestic demand. The presence of a middle class may lead to greater internal political and economic stability across emerging market countries at a time when developed nations seem more divisive.

While keen on the prospects for emerging market countries, discretion is still warranted. The assessment of sovereign risk differs from traditional credit risk in that it is more subjective. The analyst must evaluate both the ability and willingness of the obligor to make good on their obligations. Traditional credit analysis is insufficient to make an informed judgment. Aside from different legal protections for sovereigns and more complex issues of jurisdiction, determining the ability of a sovereign debtor means going beyond a conventional assessment of ratios; the character of the debt, and to whom it is owed, matters more. Sovereign nations have a wide range of solutions to manage their obligations. Debt issued in a local currency can be inflated away through the printing press. External debts can be rescheduled under terms negotiated with the IMF. Nevertheless, historical data suggest that on average the probability of a default for a given credit rating is in line with that of corporate bond issuers while recovery is likely to be slightly higher.

The gap between developed and emerging market countries is shrinking. The trend to globalization has opened the door to a larger opportunity set and better investment returns. It's time to recognize that labels do not decide the opportunity or define the risks in international investing any more than physical age decides the maturity of an individual. Rather than reminiscence about bygone days, we must with clear-eyes recognize market opportunity for what it is now and will be going forward.

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