



Brexit and Emerging Markets

The UK's vote to leave the EU has affected markets across the globe



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offers a personal opinion on Brexit and its effect on global markets

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The root cause of the UK's surprise vote to leave the European Union (EU) is the opening up of the world economy, not only in Europe but also at a wider level. In the last four decades, the global economy has effectively grown more than fivefold, from fewer than a billion people (in Western Europe, the US, North East Asia and Australasia) to closer to seven billion. China has opened up since Deng Xiao Ping, India undertook reforms from 1991, Eastern Europe ditched communism while South East Asia, Latin America and Africa became integrated to a greater or lesser degree into global supply chains and capital markets. This has lifted billions of people out of poverty, but tens of millions of the one billion in the old developed world have been left behind. Jobs have disappeared, to be replaced by other jobs, and security of employment has vanished. The EU is perceived as part of this problem, so the UK's referendum of 23 June was an opportunity to give the establishment a good kicking.

How does this affect emerging markets?

Firstly, it seems that the historical position - that political risk is significantly higher in emerging markets (EM) than developed markets (DM) is comprehensively and possibly irreversibly blown out of the water, with implications for the relative pricing of assets. Even if renegotiation with Britain's angry European partners leads to some concessions, the result of the vote gives massive encouragement for disaffected groups both in the EU and beyond, including separatist movements. Whether the Scottish nationalists under Sturgeon, France's Le Pen, separatists in Spain and Italy, renewed stress within the euro zone or the increasing possibility of a Trump win, pricing of risk across DM should surely rise.

Investors, whether in the UK or elsewhere, can no longer claim with a straight face that EM is an unusually risky asset class in light of what Britain and the rest of Europe is set to go through in the coming months and years.

Some analysts have already revised down their GDP numbers for DM whilst barely altering theirs for EM, at a time when it was in any event likely that the gap between EM and DM growth is set to expand again for the first time in five years. Many EM companies are exposed, directly or indirectly, to DM economies, but these developments should accelerate the transition of some economies from an export-oriented model to a more balanced one. Furthermore, the likelihood of a rise in US Fed Funds rates – a major concern of EMs since last December – has now dramatically receded. Recall that it was only last December, when rates first rose,



that the markets were expecting three or four increases over a twelve month period. Now, it is entirely possible that we will see none at all. This lifts a large cloud over emerging markets.

Equity Market Moves Post UK Referendum

Emerging Markets	-1.4%
UK	-8.2%
Europe	-7.4%

MSCI USD Net Total Return Indices from 23 June 2016 to 29 June 2016

Source:MSCI

Real GDP Growth	2015	2016	2017
EM: Emerging Markets	4.2%	4.7%	5.3%
DM: Developed Markets	2.0%	1.7%	1.7%

Source: Goldman Sachs Global Investment Research (post referendum)

As emerging markets specialists, we do not usually comment on the political economy of DMs such as the UK. However, we struggle to recall a time when the UK has had such rifts in both of her major parties at the same time. It is difficult to see a government or coalition arising which both reflects the opinion articulated at the referendum yet also can negotiate the exit in terms which benefits the UK's economic interests. The cut in the UK's credit rating by two agencies seems logical. An example of quite how surreal events are turning: the markets are considering in a positive light the prospect of an anti-capitalist post-election coalition of one sharply-divided party deemed unelectable (Labour) and one whose main interest is the dismemberment of the UK (SNP), simply because it may keep UK in the EU.

The EU establishment's reaction to all this has been in keeping with that of any organisation whose principal interest is survival; they are torn between a pragmatic response of doing a deal which is economically beneficial to the EU, and even to hope that somehow Britain changes its mind; and a more ideologically-driven one of punishing Britain to discourage others from following her lead. In the background, the responses of the abovementioned Sturgeon, Le Pen and Trump have been predictably gloating. Divisions in western societies are being brought to the surface and do not look like going away.

Returning to emerging markets, it is clear that globalisation won't be reversed. Whether it's movement of people, of goods or of capital, the clock cannot be turned back. Even those who've lost out in recent decades are benefiting from virtually free clothing, made across the poorer countries of the world and sold in Primark or Sports Direct; electronic gadgets put together in China; and a whole range of essential services whose low prices are supported by call centres in India. Furthermore, the exponential growth of communication via the internet and mobile networks means that many of the 'other six billion' now take as given the gains made in their economic well-being in the last generation.



A challenge facing emerging markets at the economic level continues to be that they ensure that productivity growth keeps in line with, or ahead of, wage growth. At the same time, countries need policies conducive to long-term growth, such as strong institutions, the rule of law and stable finances. Change takes time - changes to energy investment laws in Mexico, the tax amnesty in Indonesia, fiscal improvements in post-Dilma Brazil – while the pace and even the direction differs from nation to nation. However, the Brexit vote threatens at a stroke a key foundation on which prosperity and stability in Europe is based. Emerging markets seem to us a much better long-term prospect than the UK and the rest of Europe, a low-growth, heavily-indebted part of the world, addicted to unsustainably free money and which now faces the onerous task of trying to reconcile the seemingly irreconcilable.

Note:

Charlemagne Capital is a bottom-up investor in emerging markets equities. This piece, which covers macropolitical developments, should therefore be considered personal opinion rather than part of Charlemagne's investment process.

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