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Emerging Markets Spotlight

One of the challenges of investing in EM equity markets is their relative short history as an asset class, a history that is still being written, and to which recent events in Russian financial markets are adding a new and difficult chapter.

Emerging market equity started to be treated as an asset class in the early 1990s, reaching critical mass around 1994-9 as Central and Eastern Europe began to integrate with the global economy, Apartheid ended in South Africa, the Real plan began to normalize the Brazilian economy and India joined the WTO.

Financial markets display some large-scale statistical properties. One of the key ones is the opposed tendencies of momentum and mean reversion. Momentum is a positive feedback loop that is the tendency for current trends to continue (and even accelerate); mean-reversion is a negative feedback loop that is the tendency for current trends to reverse. In layperson's terms, it is 'don't fight the trend' v 'buy the dip'.

All investors must use what has happened before to shape their view of the future. A characteristic of EM equity is that the history of the asset class has previously seen only a few successful instances of markets graduating to developed market status, and only two instances of markets effectively going to zero.

In 1997, Portugal was upgraded to developed market status by MSCI; Israel was promoted to developed market status in 2007 by FTSE and in 2010 by MSCI; and Korea has been upgraded by FTSE but not MSCI. Other than Greece's brief period as a developed market, that is the history of emerging markets managing to emerge.

At the same time, while some markets have seen accessibility and liquidity decline to the point where they are reclassified from emerging to frontier markets (for example, Jordan in 2008, Argentina in both 2009 and 2021, and Pakistan in 2021), these markets have remained tradeable.

There have only been two emerging markets that have effectively disappeared. In Zimbabwe, the chaotic and authoritarian regime of President Robert Mugabe saw the economy descend into economic depression and hyperinflation in the late 1990s. The equity market became increasingly difficult to trade from 1998, but it was in 2008 that the equity market finally closed with listed companies being effectively worthless. Although never a country constituent of the MSCI EM Index, in the 1990s Zimbabwe was a constituent of the widely used IFC Composite Index and broadly considered an emerging equity market.

At around the same time, the government of President Hugo Chavez in Venezuela implemented radical populist economic policies that rapidly led to hyperinflation. In 2003 capital controls were imposed, and both the valuation and accessibility of Venezuelan equities fell very sharply. The country had been a constituent of the MSCI EM Index, but in 2006 the country was moved to a standalone index, and in 2008 MSCI Venezuela Index was discontinued, with listed equities being effectively worthless.

These two cases look less unusual in the longer history of equity investing. The twentieth century saw several equity markets close and not re-open for the purposes of pre-close investors. This includes many countries caught up in the Second World War, including Germany and Japan, but also Poland, Romania, and Czechoslovakia. Egypt's move to Arab Socialism in 1962 effectively wiped-out stock investors there, and Argentina also lost its equity market in the 1965 unrest and hyperinflation.

And, of course, there was the Russian stock market in St. Petersburg, established in 1865, which closed in 1914 for the First World War, re-opened briefly in 1917, and then closed for good with the Russian Revolution later that same year.

The Russian equity market in Moscow closed on Friday, February 25, 2022 and shows no signs of re-opening. With foreigners banned from selling, capital controls imposed, and tight financial sanctions on the country, it is likely that any remaining capital left in Russian equities is lost. In addition, the economic impact of the wide economic and trade sanctions on Russia mean that the fundamental value of Russian equities is itself highly uncertain. GDRs and ADRs of Russian stocks have been suspended, and MSCI will delete the MSCI Russia Index from MSCI EM on March, 9 2022 with a zero valuation.

Russia faced some serious political and economic crises during the period when the market traded, including in 1998, 2008 and 2014, but in each of these cases there was the political will in Russia to rebuild and recover. In the last two weeks, that has changed, and, for now, there is no prospect of any recovery.

Since its birth in the 1990s, the emerging market asset class has not seen a market of the size and importance of Russia close at effectively a zero valuation. For all investors in the asset class, it must update notions of what the downside is in emerging market equity investing. It raises the expectation of risk, without any increased expectation of return. Far more than Zimbabwe or Venezuela, it is proof that not all emerging markets survive, let alone emerge. Emerging market equity is a broad and diverse asset class, and there will always be countries and markets doing better than others, but there are no winners from this month's developments in Ukraine and Russia.

Source for all data JOHCM/Bloomberg (unless otherwise stated)