

Dubai, debt and emerging markets

By Tom Stevenson, 02 December 2009

What can the Dubai debacle tell us about investing in emerging markets?

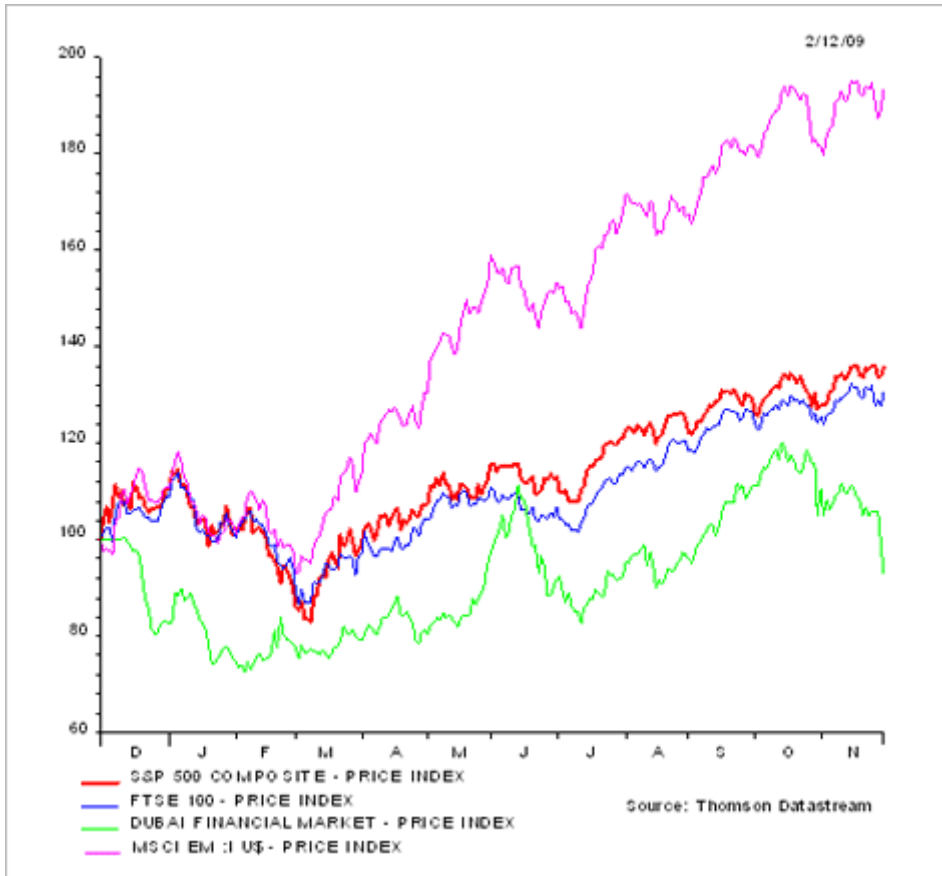
One of the more cynical definitions of an emerging market is one from which you can't emerge in an emergency. There is a grain of truth in this. When things are going well, lack of information and illiquidity might not seem terribly important, but they become acutely so if and when the balloon goes up.

The events of the past week or so have shown equally clearly that it is increasingly unhelpful to make general observations about emerging markets. They cover such a broad spectrum of investment opportunities and risks that the days of a generic emerging market response to a country specific event like Dubai's are long gone.



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The impact of Dubai's debt "standstill" was always likely to be bigger within the Gulf region than further afield. Unsurprisingly, the biggest market falls were in local markets. But the particular property and debt-related nature of the crisis and the questions it raised about sovereign backing of corporate liabilities also meant that, regardless of geography, some markets would be more affected than others.



A number of emerging markets were hit hard by events in Dubai, with contagion fears most acute in places like Greece, Ireland and Hungary which share worrying levels of debt and, in the case of Ireland, a burst property bubble. But they have been the exception that proves the rule because other emerging markets have escaped relatively unscathed.

Some of the bigger emerging markets – places like China, India and Brazil – have shrugged off the worries, principally because in purely debt-related terms they are the new safe havens. These days worries about sovereign debt are more focused on developed countries such as the US and UK than up and coming countries in Asia and Latin America.

As Fidelity's Anthony Bolton said recently when announcing his proposed move to Hong Kong to manage a new portfolio in China, developed countries have to an extent mortgaged their futures in a bid to dig themselves out of the financial crisis. The debts they have taken on to bail out their economies will have to be repaid one day and, until they are, markets will worry to a greater or lesser extent about how or indeed whether that will happen.

There are three ways for a country to deal with a debt problem: pay it off through higher taxes and/or lower public spending; inflate it away (in other words allow rising prices to erode the value of the debt over time); or default (fail to pay it back). None of these are particularly appealing for investors so the emerging markets which, like Dubai, have a debt problem will continue to find themselves in the firing line. Those which don't have the same fiscal problems, by contrast, find themselves in an unusually strong relative position compared to less fortunate emerging markets and the over-leveraged developed world too.

Even before the past week, the relative performance of the Dubai stock market and the broader emerging markets was indicating divergent fortunes. As the chart shows, the recovery in developing markets that began around a year ago had largely by-passed Dubai as investors focused on the emirate's deep-seated problems. Dubai's economy had been deliberately designed to focus on financial services, property and tourism. It was never going to be a significant beneficiary of an industrial recovery or export led growth.

Perhaps the real lesson to emerge from Dubai is that the old distinction between emerging and developed world has broken down. Old-fashioned ideas about size and safety have been shown by the ongoing financial crisis to be increasingly unhelpful in determining how to allocate our investment assets. Perhaps the new cynics will start to coin phrases about developed markets: the ones where, in a crisis, things never quite develop as you hoped.

Performance over 5 years					
	Nov 04/ Nov 05	Nov 05/ Nov 06	Nov 06/ Nov 07	Nov 07/ Nov 08	Nov 08/ Nov 09
FTSE 100	15.3%	11.5%	6.3%	-33.3%	21.1%
S&P Composite US\$	6.4%	12.1%	5.7%	-39.5%	22.2%
MSCI Emerging Mkt US\$	29.0%	30.9%	42.1%	-57.6%	80.9%
Dubai Financial Market	277.3%	-47.8%	29.5%	-63.3%	-1.2%
Source: Datastream, years from 30.11.04 to 30.11.09					

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