Print Close

Fri, Dec 27 2013. 12 14 AM IST

Gap between emerging markets' shares of global GDP and market capitalization

Was the boom in emerging markets the result of a wide gap between the region's increasing share of global GDP and low share of global market cap?

The markets are supposed to be forward-looking and it's possible they may be seeing much higher US growth in the future and a dramatic slowing of Chinese growth. Photo: Bloomberg

The year 2013 has been marked by much higher fund flows to developed markets, at the expense of the emerging markets. But was this simply the result of a recovery in the Western economies?

One way of answering that question is to take the share of emerging markets in world gross domestic product (GDP) and compare that with their share of world market capitalization. The chart shows the share of global market capitalization of the National Stock Exchange (NSE), the Shanghai Stock Exchange and the New York Stock Exchange. These shares are then compared with the share of India, China and the US in world GDP. The chart shows that while India's share of GDP fell in 2013, thanks to its very low growth, the fall in the NSE's share of market cap is much sharper. The Chinese case is even more glaring. China's share of GDP went up in 2013, despite its much talked-about slowdown, yet its share in global market cap went down. On the flip side, while the US did improve its share of GDP, the improvement in its market capitalization was much larger.

Of course, there are many factors why the share of market capitalization and the share of GDP might be different. Markets are supposed to be forward-looking and it's possible they may be seeing much higher US growth in the future and a dramatic slowing of Chinese growth. US market capitalization doesn't reflect only the strength of the domestic economy because many US firms are global and their earnings come from high-growth countries like China.

Many Chinese firms are listed in Hong Kong. In some countries, banks rather than markets provide the main source of corporate funding. Nevertheless, the chart does indicate some broad trends. Consider, for example, the situation in 2003, around the beginning of the bull run in emerging markets. At that time, the NSE's share of world market cap was half of India's share of GDP. Valuations were low and as risk appetite increased, the gap between the share of market cap and the share of GDP was bridged. In fact, the markets seem to have overshot, with India's share of GDP being lower than its share of market cap in 2007, the final year of the boom. Notice that China's share of market cap at that time was only marginally lower than its share of GDP.

Now consider what has happened after the financial crisis. The US saw its share of global GDP slip between 2007 and 2013, continuing the long-term trend, but its share in global market capitalization has gone up. Exactly the opposite has happened with China. And India has seen a marginal increase in its share of world GDP but a substantial fall in its share of market cap between 2007 and 2013.

Could it be that the boom in emerging markets was the result of the wide gap between the region's increasing share of global GDP but low share of global market cap? And once this gulf was bridged, was that a reason for emerging markets to lose favour?

A recent research paper, *Emerging Equity Markets in a Globalizing World*, by **Geert Bekaert** of Columbia University and **Campbell R. Harvey** of Duke University argues that the gap between emerging markets' share of global GDP and share of global market cap is an investment opportunity. They say: "Currently, emerging markets account for more than 30% of world GDP. However, they only account for 12.6% of world equity capitalization. Interestingly, this incomplete integration, along with the relatively small equity market capitalization, creates potentially attractive investment opportunities."

They point out that emerging markets are under-weighted in the MSCI All Country World Index (ACWI), compared with their share of global GDP. One reason, they say, is that these indices are based on "free float" and emerging markets have lower proportions of free float than developed markets. However, the lower free float does not explain all the under-weighting. The paper says, "While the emerging markets' share of free float is 12.6%, the share of total market capitalization is 20.0%. Nevertheless, this is far short of the 31.6% share of GDP they represent..."

To be sure, the gap between shares of GDP and market capitalization may well be made up by new share issues. But is there a case to be made for investing in emerging markets based on GDP weights?

The paper finds that using an annual re-balancing based on the previous year's GDP weights, the average geometric return of a GDP weighted allocation to emerging and developed markets has an annual average return of 8.3%. That's against a return of 7.4% using market capitalization weights.

In other words, using GDP weights for allocation gives an extra return.

A paper by MSCI Barra, titled *GDP weighting in Asset Allocation*, in 2010 found that over the period 1988-2009, "The MSCI ACWI GDP Weighted Index has outperformed its market cap counterpart by 2.6%, annually, with a slightly higher risk. The return to risk ratio was significantly higher for the GDP weighted version. Similar results were seen for MSCI World and MSCI EM Indices with a GDP weighted outperformance of 0.7% and 4.5%, respectively."

The December survey of fund managers by Bank of America-Merrill Lynch found that a net 10% of them are underweight emerging markets. That, combined with the lower share of market cap compared with GDP, could lead to emerging market outperformance.