JOHCM Funds

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# Emerging Markets Spotlight

## Why advanced economies such as South Korea are classed as emerging markets

**Some investors might be surprised to find countries such as South Korea and Taiwan classed as emerging markets.**

South Korea is a stable and mature democracy — and home to some world-leading technology companies. So some investors might be surprised to find it's classed as an emerging market, along with Taiwan and wealthy Gulf countries such as Saudi Arabia and the United Arab Emirates.

What is an emerging market? Who decides the definition of emerging equity markets? It's an enduring controversy. Some countries at the more advanced end of the emerging markets (EM) spectrum could arguably be classified as developed markets. It's useful for investors to understand how countries are classified as emerging markets as opposed to frontier (or pre-emerging markets) and developed markets.

**KEY POINTS**

- The term "emerging markets" was first used by the International Finance Corporation in 1980 to refer to developing countries such as Argentina, Brazil and India. Today, MSCI uses a definition based on economic development, market size, liquidity and accessibility.
- In September, a newly-elected governor in South Korea pushed a local developer into bankruptcy and reneged on a government guarantee for bonds, leading to a rapid and serious effect on domestic bonds.
- The Korean commercial paper market has seen a dramatic move due to the gap between yields and policy interest rates widening to 2.3%. To stabilize the market, the Bank of Korea and the Ministry of Finance have had to engineer a repurchase program.
- Emerging market equities typically provide higher returns than developed markets to compensate investors for the extra risk and volatility, which includes the possibility of one event causing an entire domestic market to collapse.

## THE ORIGIN OF EMERGING MARKETS

The term "emerging markets" dates back 40 years. The International Finance Corporation (an arm of the World Bank) first began tracking stock market returns in 10 developing countries such as Argentina, Brazil and India in 1980. The IFC came up with "emerging markets" as a way of describing these countries after rejecting dated terms such as "third world". The IFC based its definition on economic development, as measured by Gross National Product per capita (the annual value of a country's goods and services divided by its population).

These days the definition used by the largest index provider, MSCI[1], is based around **economic development, market size, liquidity and accessibility.** Under MSCI's methodology[2] four wealthy Gulf economies — Saudi Arabia, the United Arab Emirates, Kuwait and Qatar — are emerging markets, as are the highly successful economies of South Korea and Taiwan.

## THE CASE FOR SOUTH KOREA

Is South Korea really an emerging market? Recent events in the Korean domestic bond market show why it probably still is. The full series of events[3] are too long to go into here. But in short, a newly-elected provincial governor decided — for political rather than economic reasons — to push the local developer of a Legoland Korea theme park into bankruptcy and to renege on a government guarantee of the development company's bonds.

The effect on domestic bonds was rapid and serious. New issuance by local government development and housing companies proved impossible through October. Some major borrowers with investment grade credit ratings were unable to place bonds. The bonds that the development and housing companies issue are called Project Finance Asset-Backed Commercial Paper (PF-ABCP). They are the main funding source for Korea's private-sector property developers, who saw their bond yields spike and began scaling back finance for new projects.

In what very much looks like contagion, a mid-size life insurer delayed exercising a call option on some of its perpetual bonds.[4] Despite the specific cause, this has come at a time of rising global interest rates and bond yields, a stronger US dollar, and a slowing Korean economy. The conditions were in place for financial stress, but the combination of volatile politics and weak institutions acted as a trigger.

## DRAMATIC MOVE

The overall effect has been a dramatic move in the whole Korean commercial paper market. Three-month Korean commercial paper typically has yields 0.25-0.5% higher than policy interest rates, but the

[1]https://www.msci.com/eqb/methodology/meth_docs/MSCI_GIMIMethodology_Nov2022.pdf
[2]https://foreignpolicy.com/2022/11/10/legoland-south-korea-bond-market-crisis/
[3]https://www.msci.com/our-solutions/indexes/market-classi ication
[4]https://www.reuters.com/markets/asia/south-koreas-heungkuk-excercises-call-option-after-delay-2022-11-07/

gap at the end of November had reached 2.3% and still looked to be increasing. So, despite generally tightening monetary policy through higher interest rates this year, Korean authorities have had to engineer a repurchase program to stabilize the market.

At the time of writing, this was KRW 2.8trn (USD 2.1bn) — but its size and scope have been steadily increased and more may well be required. Ultimately, the creditworthiness of these instruments has not changed. This is a shock to confidence — a market panic in the style of the nineteenth century. The Bank of Korea and the Ministry of Finance are responding in the right way and they have the monetary firepower to settle the market at some point. But there must be some resulting drag on Korean GDP growth and corporate earnings. And this is why South Korea remains an emerging market.

## LONG-TERM EXCESS RETURNS

The long-term excess returns of emerging market equities over developed market equities compensates investors for the extra risk and volatility of emerging markets. That risk can come in many forms. But it definitely includes a single provincial politician pushing the local Legoland into default and blowing up the entire domestic commercial paper market.

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

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