BREAKOUT
CAPITAL
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Rockefeller Capital Management

The 10 Rules of Country Selection

Principles: Why 10 Rules?

Early in a quarter century of travel and investing in emerging markets, we started testing the observations and data we collected in the field for patterns with real predictive power. The rules are distilled from those travels and tests and are shaped by principles—basic dos and don'ts of forecasting---that we developed along the way.

Don't:

- Forget that high growth is impermanent, difficult and cyclical, never easy to sustain.
- Fall for straight line forecasts based on current trends, they miss the cyclical turns.
- Indulge biases, whether anchoring, confirmation, cultural, or ideological.
- Adopt excessively complex models, incorporating hundreds of factors. They include the unimportant.
- Adopt the popular but excessively simple models that explain growth as a function of one big factor—such as institutions or geography. They miss much that is important.

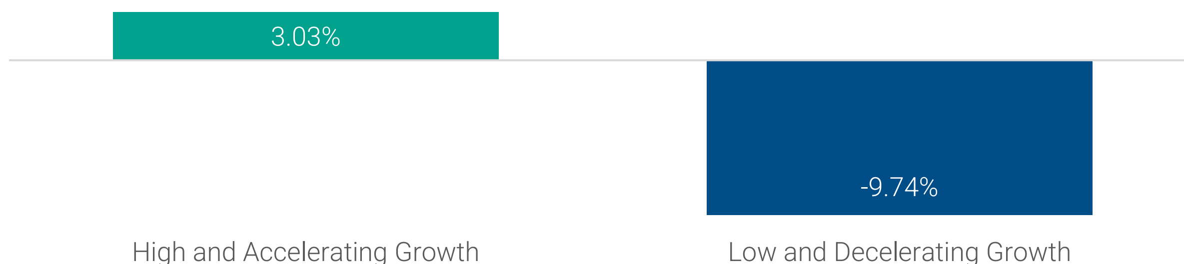
Do:

- Identify the set of factors that objectively matter most for anticipating change, focusing on a number small enough to be manageable, large enough to avoid missing critical variables. Hence, 10 Rules.
- For each factor identify the data sets with a proven track record of anticipating booms, busts and above all periods of accelerating or decelerating growth, which are the most powerful macro predictor of equity returns.
- Watch for balance in the economy, the key to sustained growth, and imbalances, the trigger for crises. Focus on powerfully predictive data that is available in real time. This is not an academic exercise, timing matters.
- Recognize that not all rules are equal: those that matter most including demographics, currency and sentiment are more heavily weighted in our scoring system than, for example, inequality and geography.
- Understand that success is always relative: today growth is slowing worldwide, but market rewards will still flow to the hottest economies in this cooling field.

- **Why country selection matters so much in EM:** Going back to the launch of the MSCI Emerging Market Index in 1988, in any given year emerging markets ranked in the top 20 percent for GDP growth typically outperformed the index by 4 percent per year over the next three years; those in the bottom quintile typically underperformed by 0.7 percent. The performance gap is even more dramatic when growth in economies is both high and accelerating compared to nations where growth is low and decelerating (see chart below)

Accelerating Growth, Exceptional Performance

Quarter-by-quarter 3-year annualized market returns relative to MSCI EM Index



The 10 Rules in Brief

Population: Population growth sets the speed limit on economic growth

Politics: Systems, democratic or autocratic, matter less than cycles

State: Size, big or small, matters less than policy and attitude toward business

Debt: Size of debt matters, pace of increase matters more

Currency: Cheap is good if stable, but key is avoiding dodgy measures

Investment: More is better—up to a point and depending on its target

Inflation: Consumer prices matter but so do asset prices

Geography: Matters in evolving ways, as deglobalization brings supply closer to home

Inequality: Matters as much for politics as economics, distorting both

Hype: Look for countries global investors don’t love or hate, just ignore

1. Population

Historically, going back to the dawn of the industrial revolution, economic growth has been a function of population and productivity, or more workers and more output per worker, with each contributing roughly a half of overall economic growth. While growth in the working age population shifts slowly and is not a dynamic predictor of booms and busts, it does set a speed limit on growth. In an era of depopulation, the limit is falling worldwide.

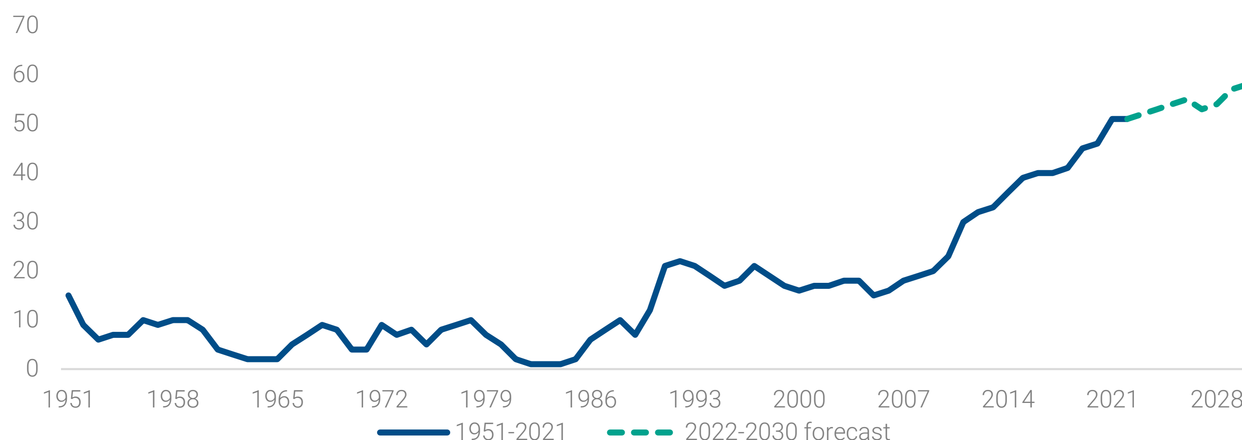
Countries with a working age population growth rate below two percent have a weak chance—one in four--of sustaining economic growth above 6 percent.

Countries in which the working age population is shrinking have an average growth rate of just 1.5 percent, and a near zero probability of sustaining growth above 6 percent.

This is hugely consequential, given that the number of countries with a shrinking working age population has risen from 2 in the early 1980s to more than 50, including all the major powers outside the United States, and is still climbing.

The Demographic Bust

Number of Countries with a Shrinking Working Age Population



Source: UN.

Though some 60 countries still have a working age population growth rate above 2 percent, most are small Sub Saharan states and only three have investable markets: Pakistan, Nigeria and Kenya. Those nations have a distinct demographic edge over those with shrinking populations. So does another relatively small subset of nations with working age population growth above 1 percent, including India, Mexico and the Philippines, at least for now. Even in those countries the long-term population growth trend is generally downward.

To identify nations most likely to thrive despite these tough demographic conditions, we track government policies that can have a significant near-term impact on the working age population by drawing (or failing to draw) mature workers—including women, immigrants, the elderly, and robots—into the labor force.

To a large degree, the rest of the rules address the second half of the growth story, productivity.

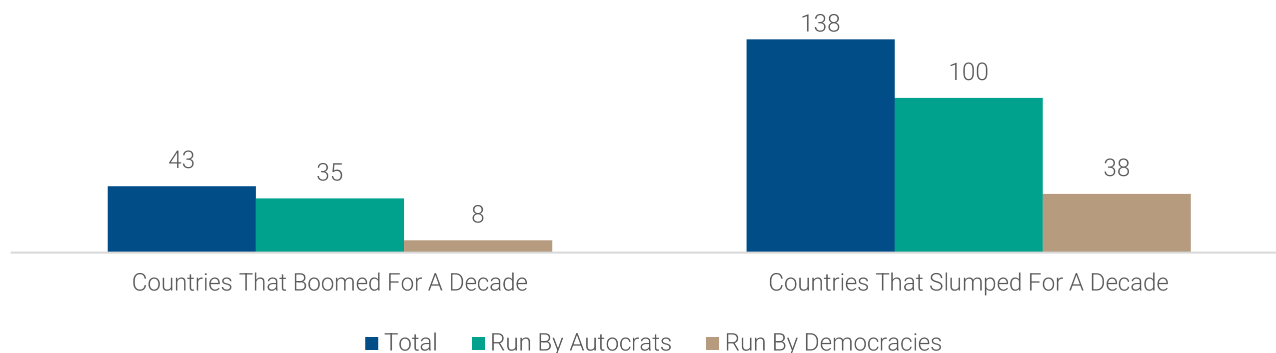
2. Politics

Politics matters most for growth everywhere but matters by far the most in emerging markets, where political leaders are often strong and institutions often weak.

Systems: The rise of China has led many to believe, incorrectly, that autocracies have an economic advantage. In the postwar era, autocrats presided over most long economic booms, and over an even greater share of the far more numerous long busts. On average, growth has not been stronger in autocracies, but has been more volatile at both extremes. See the chart below.

The Democratic Advantage: Stable Growth

Number of Decade Long Booms and Slumps, Back to 1950



Source: World Bank, Haver Analytics, Politi-Score. Analysis covers 150 countries going back to 1950

More than system, our political rules focus on where a country and its leadership stand on several highly telling cycles.

Crisis and reform: Most important is the tendency of virtually all countries to reform only when facing a crisis, for reform to lead to recovery, for recovery to lead to complacency, and for complacency to set the stage for a new crisis. Identifying where a country stands on the cycle of reform can provide a very telling clue to its economic prospects.

Stale leaders: Closely related is stale leader syndrome: positive economic reform is most likely under a new leader, particularly one swept to power in a crisis, and increasingly less likely the longer a leader stays in power. Even leaders who arrive in power as heroes of economic reform tend to grow increasingly complacent, stale and erratically autocratic over time. Faced with a crisis, stale leaders often pretend it's not happening. Right now the average EM leader has been in power around 7 years, but the leaders of Russia, Turkey and several other EMs have been in power much longer.

Fresh leaders: Stock markets tend to outperform strongly under newly elected EM reformers but gains are concentrated in the first 24 months, and flatten out over time.

Of populists and technocrats: In general, markets tend to project their own views onto national elections, expecting voters to embrace globally minded technocrats and reject left wing or nationalist populists. They also typically fail to distinguish between reckless and practical populists, who rise in a time of crisis and at least early on push the requisite reforms—a broad class that includes the early years of EM giants like Recep Tayyip Erdogan, Luiz Inacio Lula da Silva and Vladimir Putin.

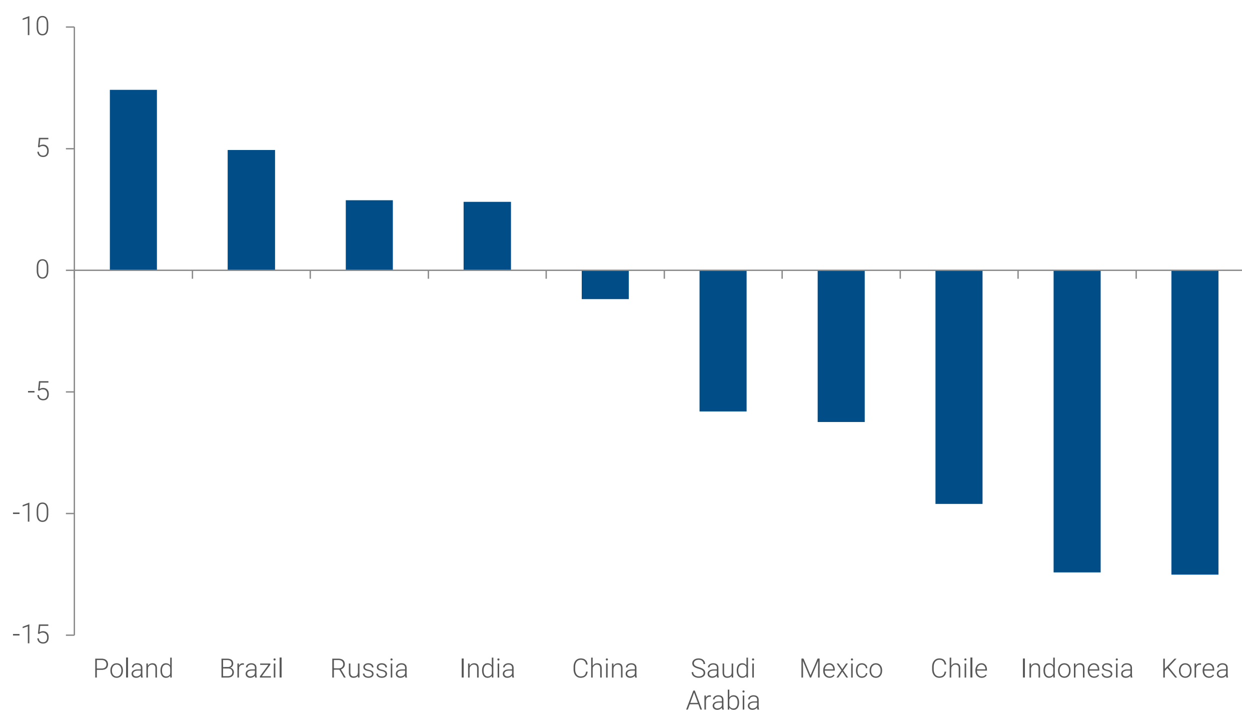
3. State

Since many of the ideological battles of the last century come down to the power and role of the state, it is particularly important to suppress ideological bias on this subject. Broadly, we watch for states that are either suspiciously large and growing for their income class, or suspiciously small and shrinking, measured by state spending as a share of GDP.

Bloated states threaten to crush the private sector, but anemic states can undermine growth just as surely by failing to provide even basic infrastructure and security. In Latin America, despite a general reputation for meddling states, Pacific nations such as Peru and Chile tend to have undersized states relative to their peers, while Atlantic nations such as Brazil and Argentina tend to have oversized states. In a frontier market such as Pakistan, the weak state creates a sense of insecurity and fragility that discourages investment and undermines growth.

Fat State, Skinny State

Emerging Countries, Rank by How Far Public Spending as a Share of GDP Departs from the Norm for their Income Class (In Percentage Points)



Source: Haver Analytics, IMF; data as of 2022.

Beyond size, we track state performance, particularly in response to crises.

State Stimulus: The track record is quite clear, emerging markets which borrow heavily to spend their way out of recessions and financial crises will pay for it with high debts, which slow growth in the future. In general, emerging markets went into the crisis of ’98 in weak financial shape, which constrained their spending, and came out strong. They went into the crisis of ’08 financially strong, overspent and came out weak. Now, amid the pandemic, many EMs went in financially weak, and once again those that respond with restraint are likely to come out strong.

State Sectors: Key to watch is the expansion or contraction of state banks, which despite years of privatization and reform still control a third of bank assets in the typical large EM. Given the political influence on state owned banks, they tend to be sinkholes of bad loans and misallocated capital, with negative effects across the economy. Another key is state subsidies for energy, which unlike food subsidies tend to go mainly to the rich (who own cars) and represent a shockingly high share of GDP in many EMs (more than 10 percent in Egypt and Saudi Arabia).

State role: We look for shifts to greater balance, in the size and influence of the state. In the current era of growing government interventions, regulation and stimulus, reform typically involves measures that reduce the size and reach of the state. One simple way to define positive state reform is that it tends to expand not restrict access to the basic inputs of growth--land, labor and capital—and thus positions an economy for faster growth.

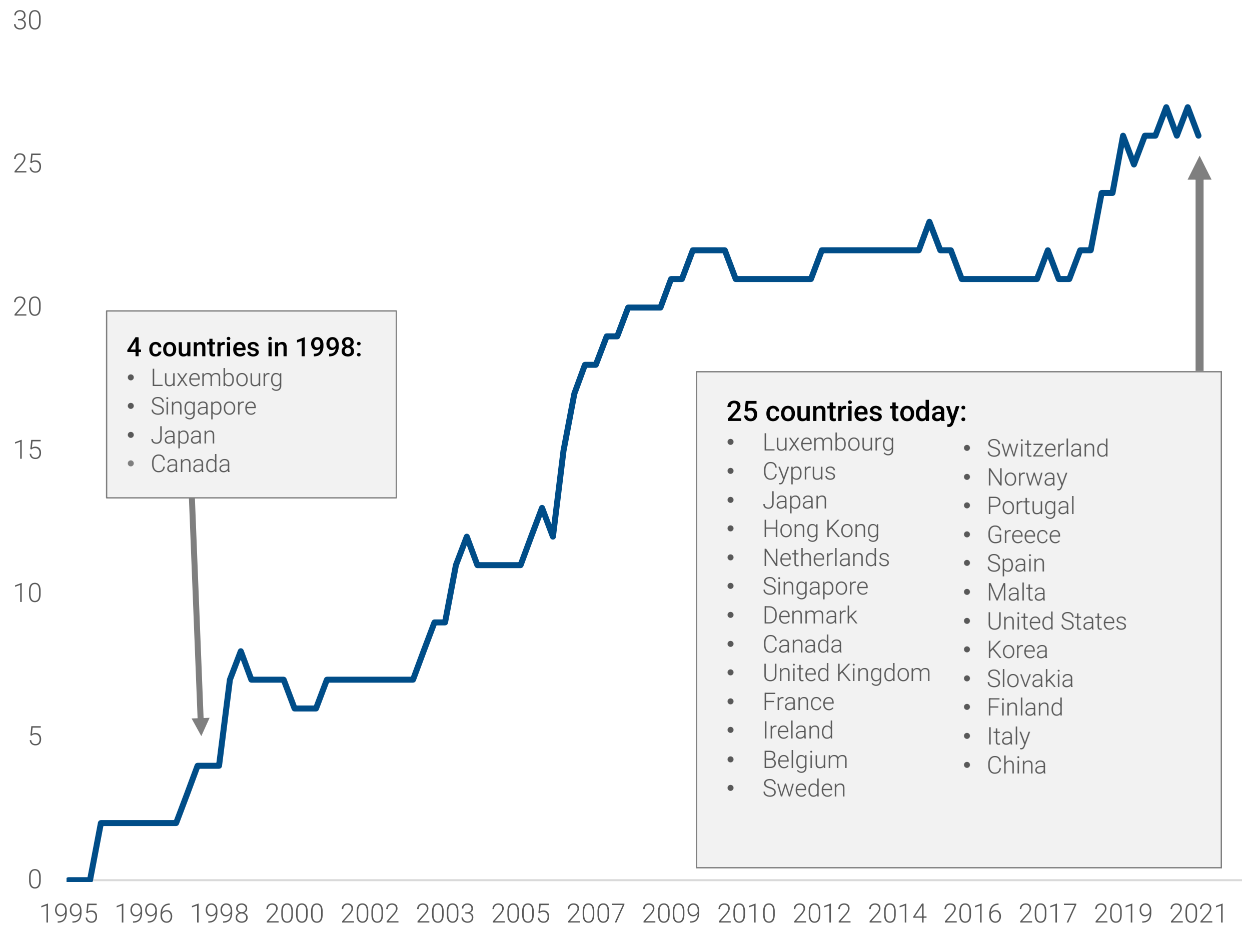
4. Debt

Over the last four decades, as the Fed became central bank to the world, and easy money led to financialization of economies everywhere, debt rose from 100 percent to 350 percent of global GDP. The faster debt rises, the more central it has become to cycles of boom and bust. In a way credit, the lifeblood of capitalism, has become an intoxicant threatening to kill it.

Total size of debt matters, but the pace of increase or decrease is a better predictor of both crisis and recovery.

The Global Boom in Debt Burdens

Number of Countries with Total Debt Above 300% of GDP



Source: IIF, Haver.

Crisis warnings: If debt has been growing significantly faster than the economy for five years running, trouble looms. Looking back to 1960 for 150 countries, we isolated the 30 most severe credit binges, from Japan in the 1980s to Thailand in the late 90s. The most powerful indicator was private credit, which grew by at least 40 percentage points as a share of GDP, leading in most (18 of 30) cases to a financial crisis, and in virtually all cases to a prolonged slump, with GDP growth falling on average by half over the subsequent five years.

The same basic pattern holds even for lesser credit binges: if private credit grows by even 25 percentage points as a share of GDP over five years, GDP growth slows on average by a third over the next five years.

The private sector leads, the state follows: Historically, public debt tended to start rising only late in the cycle, as government stepped in to bail out bankrupt debtors. Of the roughly 460 debt crises worldwide between 1970 and 2015, nearly five of six was triggered by the private sector. That sequence may be changing, however, as governments become more deeply involved in trying to minimize the impact of each successive financial crisis.

The path of the slowdown depends on how quickly the government can stabilize the debt to GDP balance, by either resolving debts or restoring GDP growth. Debt binges focused on real estate tend to be the most sticky, because it can take years to negotiate who takes the pain, lenders or borrowers.

Governments that try to protect all lenders and borrowers from losses, like for example Japan after the 1990 crisis, tend only to build even more debt and prolong the resulting slump.

Recovery signs: If debts are left free to fall, a prolonged period of private debt growth slower than GDP growth typically sets up the economy for a healthy new credit cycle, and a boom. In addition to falling private credit/GDP, another telling sign is the loan to deposit ratio. A ratio above 120 percent signals potential trouble--banks may have trouble covering their loans. A sharp subsequent decline in the ratio signals quick recovery—as was the case in Indonesia within a year after the 1997 crash.

Debtophobia: there is a clear but fine line between a return to cautious lending, as in Indonesia, and a long-term fear of debt. Debtophobia, with private credit shrinking steadily as a share of GDP, seized Mexico after the crisis of '94 and lasted a quarter century, leaving growth stagnant.

5. Currency

Cheap is good, and currency appreciation accounts for a third of equity returns in emerging markets. The issue is how to identify cheap.

None of the existing measures is fully reliable, and all are subject to political manipulation (cherry picking start dates for comparison, for example). One fix is to visit: a competitive currency will feel cheap to outsiders, obvious in the price of their hotel room or a cup of coffee. We use on-the-ground impressions to double check our preferred official measure (REER 10y deviation).

Crisis warnings: The current account, which reveals whether a country is spending beyond its means, is the key barometer. If the current account deficit grows faster than GDP for a sustained period, confidence in the country's ability to pay its bills can collapse, triggering a run from the currency.

Screening for current account deficits of various size in 186 nations back to 1960, we found some basic guidelines. If the current account deficit averages 5 percent of GDP or more for five years, GDP growth falls by an average of 2.5 percentage points over the next five years, with an 80 percent probability of financial crisis in that period. If the deficit runs at 3 percent, a slowdown is still likely, but is also likely to be relatively mild.

Below 3 percent, a persistent current account deficit can be a surprise positive, if money is flowing out of the country to buy machines that generate growth, rather than to import frivolous luxuries. To tell the difference, we look at fixed capital investment; if it is rising, it suggests that money is not flowing out mainly for French wine and perfume.

Contagion dynamics: When one emerging market currency falters, investors tend to flee others, troubled or not. In 2013, for example, investors fled from a real current account deficit problem in Turkey and then from minor ones in India and Indonesia, but with predictable results. India and Indonesia recovered quickly, as slight declines in their currencies were enough to restore current account balance. Turkey, having run a current account deficit above 5 percent for five years, entered a prolonged slump.

The wild card here is deglobalization. Capital flows have been in sharp decline as a share of global GDP since 2008, and the largest share of those flows was in bank loans, which means it is increasingly difficult for any nation to borrow abroad and spend beyond its means. In other words, currency crises and contagions may start faster (after less deterioration in the current account) than they did in the past.

Follow the locals: Though currency crises are often blamed on the flight of evil foreign speculators, our research shows that locals were first to flee in 10 of the 12 major emerging market currency crises over the last three decades. Data buried in the balance of payments shows that Mexicans started dumping the peso 18 months before it collapsed in 1994, Russians started selling the ruble two years before it collapsed in 1998, and so on.

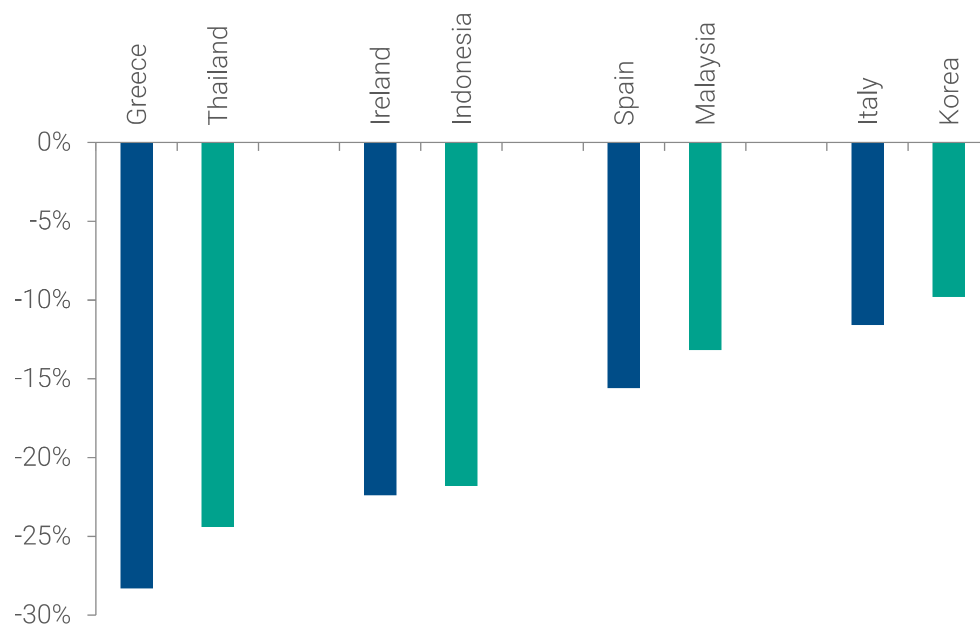
Foreigners ended up selling larger sums but started selling much later, and got crushed in the collapse. And in seven of those 12 crises, locals were also first to start buying as the currency recovered. For early signs of currency trouble or rebound, we watch the locals, who have better domestic intel than big global investors sitting in New York or London.

Recovery signs: When the current account shifts from deficit to surplus, it usually signals that the currency is stabilizing at a competitive rate, which promotes exports and discourages imports. The country is living within its means. A flexible currency, with a value set by markets not fixed by the government, is a critical advantage.

Compare the Asian crisis of 97-98 to the Eurozone crisis of 2010. The currency and GDP declines in the hardest hit nations were nearly identical, but Europe recovered much more slowly. In Asia, countries quickly dumped the dollar peg, currencies collapsed, imports fell and exports rose, current accounts shifted to surplus. Within four years, Asia had fully recovered. In Europe, by contrast, crisis-hit nations could not dump or devalue the Euro, and thus could regain competitiveness only through a dreaded “internal devaluation,’ including cuts to wages, public payrolls and welfare. Four years on, Europe was just starting to show any improvement in the current account and had yet to recover.

Asia 1998 versus Eurozone 2010: Similar Crises, Different Recoveries

Real GDP: Max Fall from Trend in the 4 Hardest Hit Countries



Source: Haver Analytics.

6. Investment

Though investment typically accounts for a smaller share of GDP than consumption or government spending, it is the juice that makes the economy grow, creating the new businesses and jobs that put wages in consumer pockets and taxes in the treasury. The most volatile spending category, investment leads recessions and recoveries, and so matters most to forecasting change.

The sweet spot: Our research on the most successful postwar economies, in which growth topped 6 percent over a decade or more, shows that on average they were investing at least 25 percent of GDP during the boom. Typically, growth picks up as investment accelerates, so we look for investment that is high and rising, between 25 and 35 percent of GDP.

When investment surpasses 30 percent of GDP it tends to become monophasic—stuck on one path—generating a virtuous cycle of rising prosperity and productivity that lasts on average for nearly a decade.

The weak spot: On the other end of the scale, we watch for investment that is below 20 percent of GDP and falling, a combination that has accompanied stagnation in Brazil, Mexico, Nigeria and other emerging economies for years.

Good binges/bad binges: The value of an investment boom can be measured by what it leaves in its wake. Investment binges in manufacturing, railroads and canals, and technology have all left behind infrastructure that continued to boost productivity for years. Real estate binges create more shelter but have little impact on productivity.

Commodity binges can (and do now) create enormous growth and investment opportunities but tend to fail as long-term growth strategies, temporarily boosting prices and undercutting productivity. Most of the big oil exporters have seen their per capita incomes shrink, relative to the United States, since they discovered oil.

The exceptions involve investment in new tech for old resource industries, such as shale oil drilling systems. These are tech booms in commodity outerwear. We judge an investment boom by its targets.

The point of excess: Any strength taken too far becomes a weakness, and the biggest investment booms on record tended to go too far, leaving a landscape littered with idle factories, unfinished malls and office parks. Once investment peaks above 30 percent of GDP it too tends to become monophasic, entering a sticky downward path that slows growth by a third on average over the next five years. If the peak is over 40 percent of GDP, growth slows even more sharply, by about half over five years.

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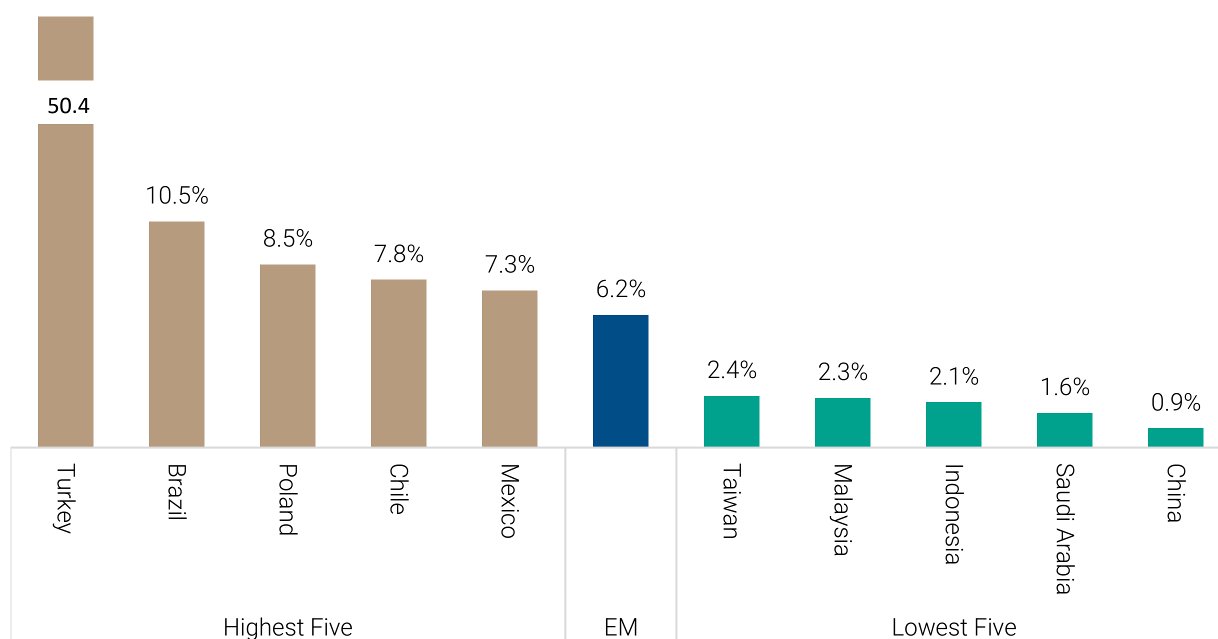
7. Inflation

Now that consumer price inflation is making a global comeback, so is its power as a forecasting indicator.

The postwar Asian miracles sustained inflation rates below the EM average, thanks to strong investment and productivity growth, over the course of their long booms. The rule is that an inflation rate much above the EM average is not (as politicians often claim) usually a healthy byproduct of hot growth. It is likely a sign of dysfunction, weak investment, lagging productivity. After peaking at nearly 90 percent in 1994, the average EM inflation rate fell to 4 percent and stayed there, drifting back upward only recently, amid the pandemic, to around 6 percent (excluding the worst outlier, Turkey).

Price Watch

EM Inflation Outliers



Source: Haver Analytics, EM is median within 17 major EMs ex Turkey, Data is as of February 2022, chart plots the year on year CPI

Inflation and politics: It is particularly worth remembering now that inflation has often triggered the cycle of crisis and reform in politics, toppling multiple governments from Brazil to Turkey and India and helping to trigger the fall of communism in Russia and the Arab Spring revolts. Rising food prices, in particular, are often a precursor to political revolt.

Inflation fighting: Governments can fight inflation, and the key weapons to watch for include openness to global competition and trade, of the kind many leading emerging markets are scrapping now in favor of “self reliance.” Another is sound financial management, of the kind the 1990s generation of reformers (then including Putin, Erdogan and Lula) first brought to emerging markets. And independent central banks committed to containing inflation below clear target rates are back on the frontline, now that inflation threatens to break those targets.

Good and bad consumer price deflation: Recall that only a year or two ago most observers were less worried about inflation than about doggedly low inflation and the dread “Japan scenario,” excessively so.

Japan is the only major nation to suffer a long bout of deflation since the 1930s. It is an odd exception, not one example of a pattern. Moreover, deflation in Japan was the bad kind, driven by slumping demand that retarded growth. In recent decades many other nations have suffered shorter bouts of deflation, both the bad kind and the good kind, which is driven by expanding supply and rising growth. The risk that consumer price deflation will be the bad, Japanese variety is no more than 50-50.

The kind of inflation that matters most: Nonetheless, spooked by Japan, central banks were pumping out liquidity to prevent consumer price deflation, fueling a bigger risk that almost always ends badly: asset price deflation. Since World War II, and the spread of global finance, the share of recessions that followed a crash in asset prices (stocks or real estate) has risen from one of every four to three of every four. An added irony: when asset market booms go bust, the losses can depress consumer spending and trigger bad consumer price deflation as well. That is what happened in Japan.

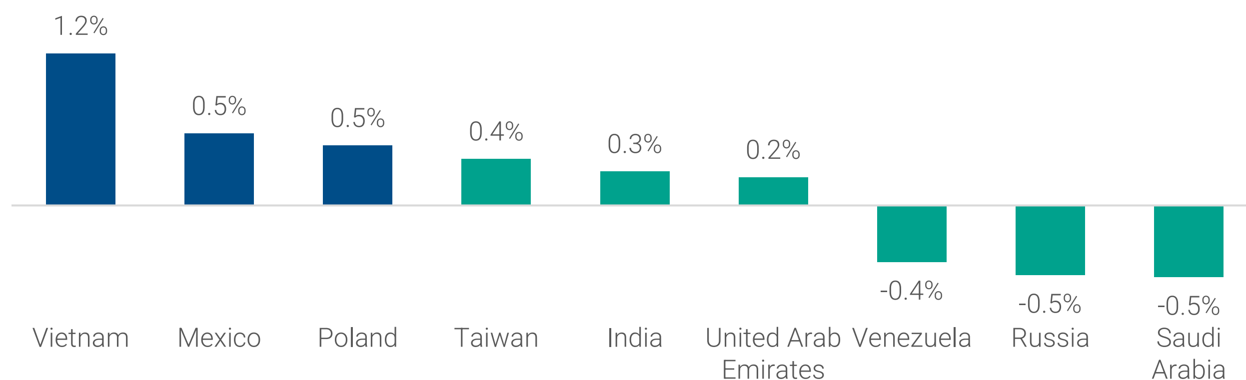
As a rule, we monitor potentially destabilizing bouts of asset price inflation as closely as consumer price inflation. Global markets including only stocks and bonds were about the same size as the global economy in 1980. Now, after four decades of increasing central bank support, which reached dizzying extremes during the pandemic, the $410 trillion markets are well over four times the size of the global economy. Though most analysts still worry more about what tremors in the economy can do to markets, the bigger risk is what tremors in the market can do to the economy.

8. Geography

In a deglobalizing age, the export manufacturing path to prosperity isn't closed, just narrowing. The winners are nations still increasing their share of global factory exports, as producers shop for lower costs outside China. See the chart below.

The Export Path to Prosperity

EM Ex-China Biggest Winners and Losers In Share Of Global Exports By Country Since 2010 (Percentage, % of Global Exports)



Source: UNCTAD. Data as of December 2020.

To spot nations with the potential to thrive in export competition, we look first at the map, for the good luck of location. Nations that have thrived in export competition in recent decades cluster in Southeast Asia on major trade routes to the vast consumer markets of the United States and Western Europe, or next door to those markets, in Latin America or Eastern Europe.

Next we look for good policy, specifically for countries opening doors to trade with the world, their own region and their immediate neighbors. Finally we look at internal balance, whether a country is promoting growth nationwide or favoring big cities.

One simple rule of thumb is to look at changes in the balance of population between the first and second city. In mid-size nations with a population between 20 and 100 million, the most successful (the Asian miracles) all had first cities roughly three times the size of the second city. Those with a second city ratio much higher than three to one (such as Thailand) have been vulnerable to disruptive provincial revolt.

In larger countries, we look not at the second city but at changes in the number of second cities, those with a population of more than 1 million. The differences reveal striking contrasts in growth patterns and prospects. China has 19 boom cities, which grew over the last three decades from less than 250,000 to over 1 million in population, often well over 1 million. India has two, both barely over 1 million, both largely a result of redrawn borders rather than internal growth. This contrast speaks volumes about Indian policies that retard regional growth.

Balanced domestic growth is increasingly important in an era of deglobalization, so we also track countries that are protected by large domestic markets and a high domestic demand share of GDP, which include India, the Philippines, Mexico and Brazil. They are best positioned to grow independently, regardless of cooling trends in international commerce.

9. Inequality

We were tracking inequality before it became a hot button global issue, for what many now acknowledge is its clear capacity to retard growth. Rising inequality can distort an economy both directly, by steering gains to those least likely to spend additional income (the wealthy), and indirectly, by triggering populist revolts against the process of wealth creation itself. These revolts have a long, disastrous history in emerging nations especially.

The challenge is that standard measures of inequality are updated too rarely and erratically to allow for real time comparisons across countries, so years ago we started analyzing the Forbes billionaire list, which is at least updated yearly, using a consistent standard. To pinpoint the most and least bloated national billionaire elites, we calculate billionaire wealth as a share of GDP. To identify entrenched, family-based elites, we tally the share of billionaire wealth that comes from inherited fortunes, which are far less widely celebrated than self-made fortunes.

Most important, we distinguish “good” from “bad” billionaire elites by calculating the share of their wealth that comes from generally clean, productive industries — particularly technology and manufacturing — as opposed to industries such as real estate or commodities. No doubt, this miscasts many oil or real estate tycoons. But in general those industries are less productive, more prone to corruption and enjoy less goodwill, particularly in emerging countries. Thus the sight of too many billionaires rising in those fields is more likely to incite populist backlashes. The chart below scores the top ten emerging markets on these three billionaire metrics.

Slicing Billionaire Wealth Three Ways

EM Country	Total Billionaire Wealth/GDP	Bad billionaires' wealth/total billionaire wealth	Inherited billionaires' wealth/total billionaire wealth
Brazil	14.2%	3.3%	41.4%
China	15.2%	19.7%	2.2%
India	19.6%	11.9%	55.4%
Indonesia	7.3%	4.2%	66.0%
Mexico	11.4%	74.9%	47.0%
Poland	3.2%	0.0%	18.2%
Russia	34.3%	59.7%	0.2%
South Korea	6.7%	4.9%	44.5%
Taiwan	15.2%	9.5%	35.0%
Turkey	6.9%	10.0%	45.3%
Average	13.4%	19.8%	35.5%

Source: Data from Forbes Billionaire List 2021, analysis by Breakout Capital.

Slicing the billionaire list by size, industry and family roots allows us to capture multiple sources of social resentment, as well as counter trends that may ease resentment. A growing billionaire class is not as likely to provoke revolt if most of their wealth is self made or arising in “good” industries. For each country, we compare its score in each of the three categories to the EM average, in order to spot those that are clear outliers, possibly at risk.

While the market boom during the pandemic has triggered a billionaire population explosion worldwide, the biggest increase came in China, where in 2020 billionaire fortunes doubled as a share of GDP to 15 percent. Though most of this wealth is coming from tech and other good industries, the communist party finds it increasingly difficult to square this gilded age with what’s left of Maoist ideology, which helps explain the recent, stunningly aggressive crackdown on its growing billionaire class.

The pattern is increasingly clear: over the last two decades booms in billionaire wealth by scale, industry or inheritance have been reflected in populist outrage from India to China, Mexico and Russia, where the billionaire class is bloated, politically connected and concentrated in Moscow, and heavy with bad billionaires. Its low share of inherited wealth is misleading, since private fortunes arose only after the fall of communism, too recently to pass on great wealth to a second generation. What keeps the lid on social discontent is likely the risk of challenging the current order.

The power of this rule is growing stronger as the global billionaire population booms. It surpassed 2700 last year, up from 2000 the year before and just 300 at the turn of the millennium. The fact that the recent boom was dominated by good billionaires in the tech sector may have taken some edge off the backlash to date, but the list still needs to be watched closely for warning signs.

10. Sentiment

The conventional wisdom in the media and thus in the market can be relied on to assume past trends will continue indefinitely, rather than to anticipate coming crises and booms.

The pattern has repeated itself for decades. Hype for the Philippines, Burma and Argentina in the 50s and 60s, for Venezuela and the Soviet Union in the 70s, for Japan in the 80s, the Asian Tigers in the 1990s, and the BRICs in the 2000s, always continued long after it was justified. Observers rarely spot cracks in the story, even when they are obvious. Two years after the Tokyo crash of 1990, presidential candidate Paul Tsongas declared, “The Cold War is over and Japan has won.”

Once the hype bubble finally does pop, love turns to hate. Indomitable Japan became pathetic Japan. Praise for the “Confucian” discipline of the Asian Tigers gave way to exposes of crony capitalism in Bangkok and Jakarta. This period of hate is a risky one, because often there is a strong element of truth in the exposes. Investors who rushed back into Thailand too quickly in 1998 left a lot of their own “blood on the street.”

We watch for the next phase, when the media moves on to the next hot story, and investors have yet return. Not always (see Burma and Venezuela) but quite often, it is when emerging markets fall out of the spotlight that they go to work, put their financial houses back in order, and set themselves up for another run of strong growth and returns.

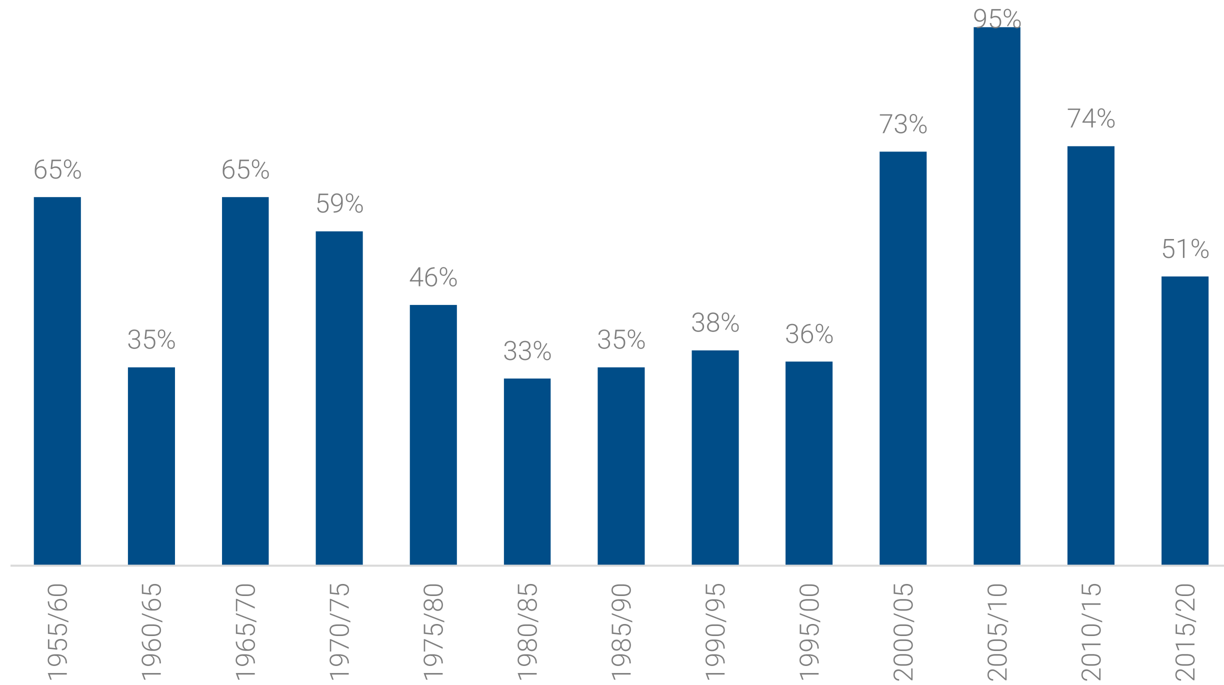
We track two key indicators of sentiment. First, market cap/GDP, relative to the emerging market average; a low ratio can signal indifference and neglect. Since in some EMs this ratio gets a perennial boost from international listings, we also track change in the ratio relative to the market’s own history, as a signal of changing sentiment. Second we track net portfolios, again both relative to other EMs and to the market’s own history, for real time signals of excessive love (a sell sign) and excessive hate or indifference (a buy sign).

The basic point here is not to mock the conventional wisdom in media and the markets. They tend reasonably enough to follow the consensus of expert forecasts, which are the real problem, succumbing predictably to straight line bias. Between 1989 and 2014, there were 220 cases in which an economy grew one year but contracted the next. The IMF’s spring forecasts for the year ahead did not anticipate even one of those downturns.

The lesson goes back to one of our core principles; understand that growth is impermanent and cyclical, so watch above all for change—for markets entering periods of accelerating or decelerating growth. In a typical year, more emerging economies will be falling behind in average income, relative to the United States, than catching up. Mass convergence, the idea that “the rest” would continue rise as one, was a myth, born of the perfect storm of positive economic forces that lifted virtually all emerging countries in the 2000s. In any decade, many emerging markets will be on the rise, but few will put in a second straight decade of hot growth.

Mass Convergence Was a Late 2000s Illusion

Percentage of countries 'Converging'



Source: Breakout Capital research, Haver Analytics data as of April 2021.

Today the postwar booms in population and globalization have passed. Rising debt and reactionary populism threatens growth in many countries. The double digit growth rates achieved by emerging market stars in the postwar "miracle" years are no longer possible, but no matter. In the global markets, what matters is not absolute growth but relative growth. Money will continue to flow to relative winners. And following the rules increases the probability of identifying the winners for any given decade.

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