

## Strategy Matters

Issue 2008 – 10

### Emerging Market Re-coupling?

**The growth slowdown may be broadening out to emerging economies (EM). Future trends in individual countries' leading indicators, metals prices and capital-producing countries' exports to EM should be monitored to determine whether an EM slowdown is, in fact, underway. If there is a slowdown underway, there are important implications for global asset markets.**

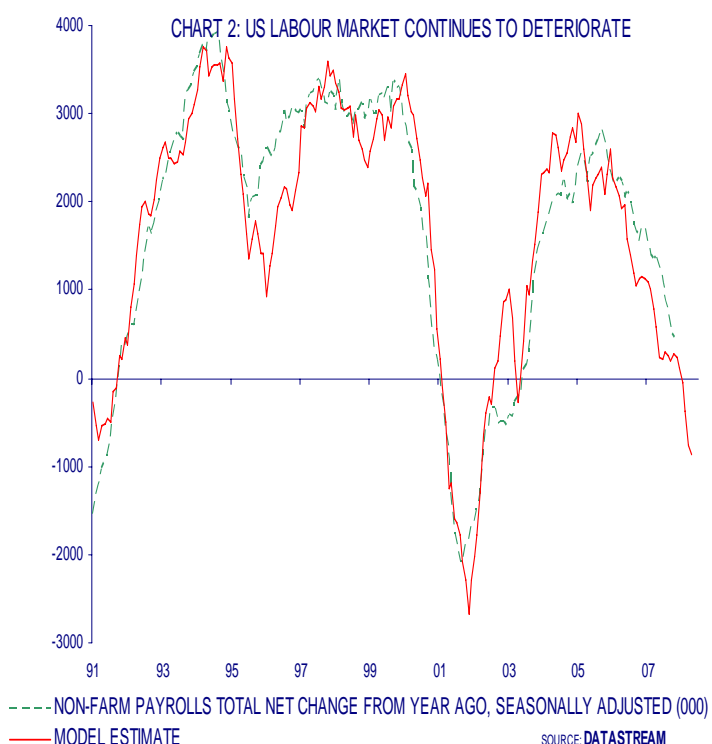
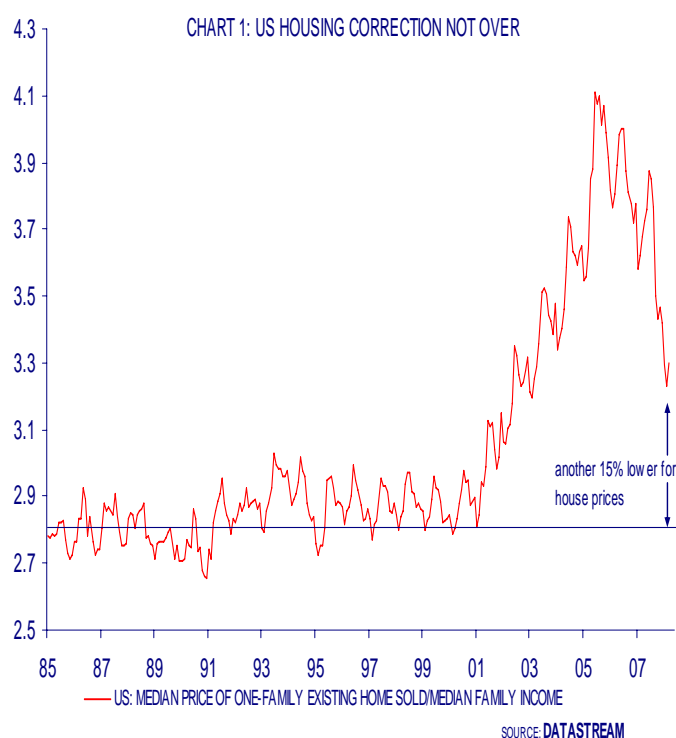
#### Global demand continues to downshift...

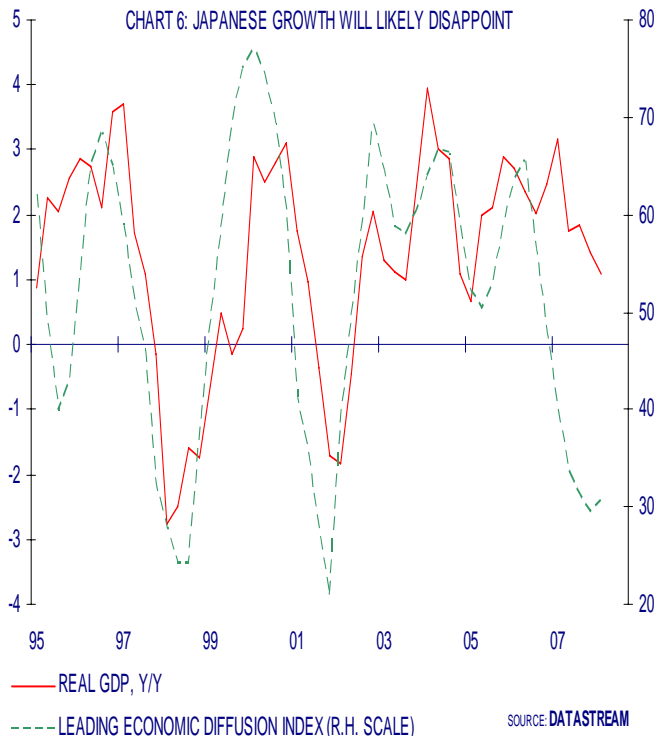
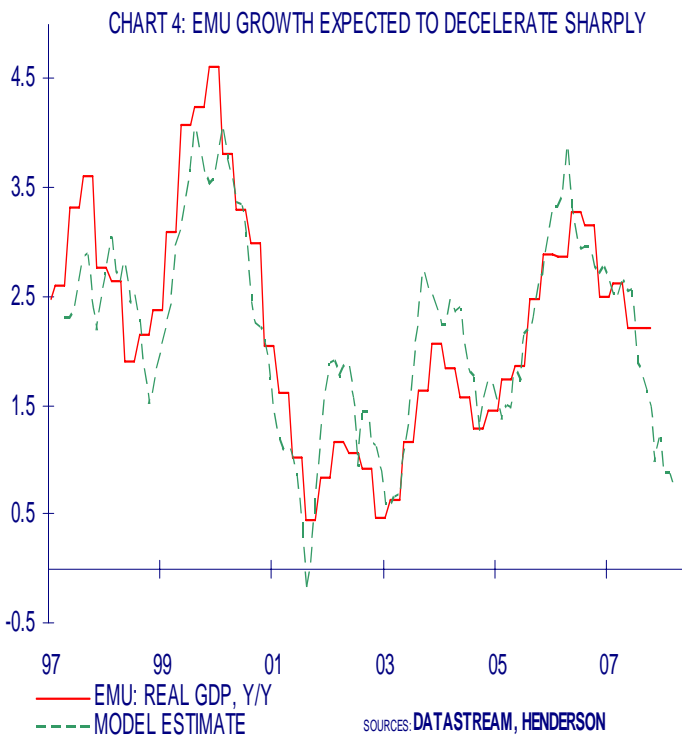
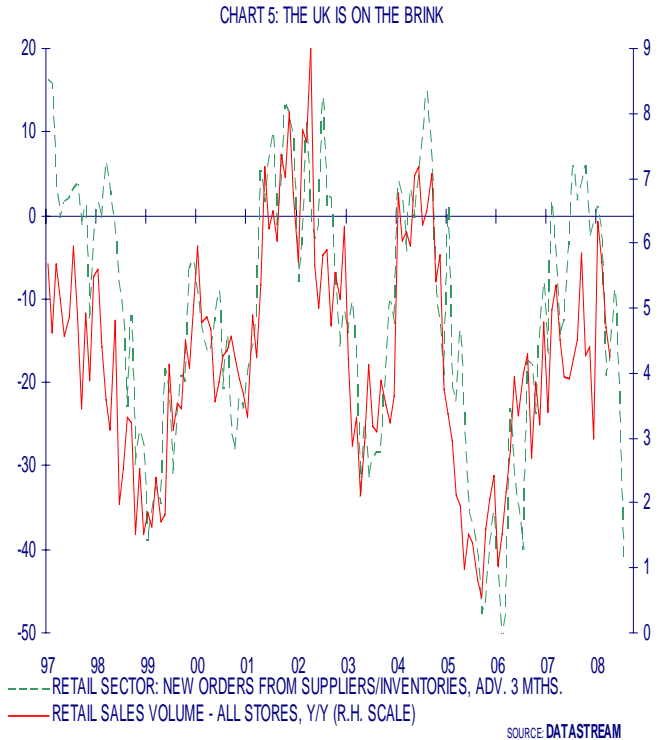
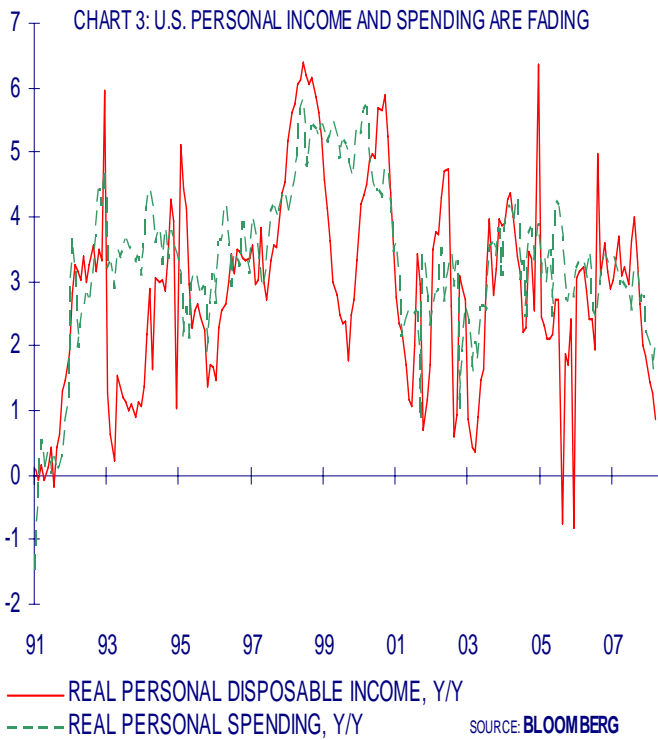
The G7 slowdown, led by the US, continues to progress. Despite a substantial easing in monetary policy and a fiscal package which should give a boost to Q2 GDP, it is too early to signal the 'all-clear' on US growth. Residential real estate continues to correct, and the labour market is in the process of adjusting lower taking consumer income and spending with it (Charts 1, 2 & 3). European and UK growth are also set to slow further (Charts 4 & 5) and Japan's economy looks likely to continue to disappoint (Chart 6).

Emerging market demand has remained resilient throughout the growing slowdown in the developed world thanks to a multi-year investment boom and strong consumption growth (Chart 7). However, there are budding signs that this source of demand may too be slowing.

#### ...and the slowdown may be set to accelerate.

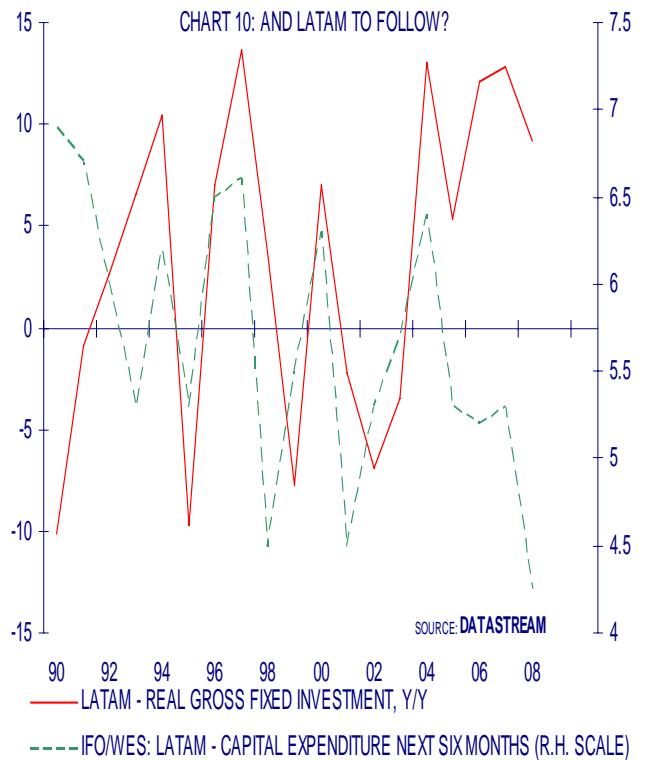
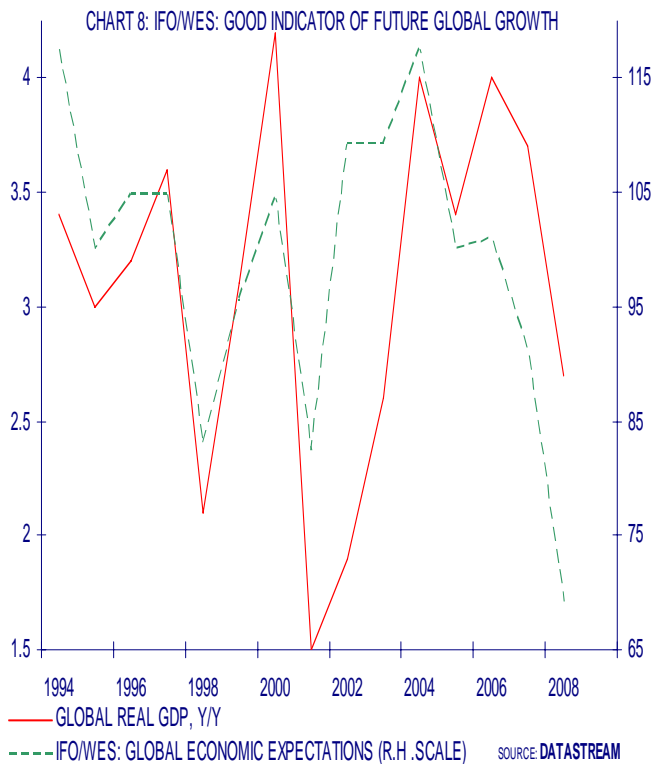
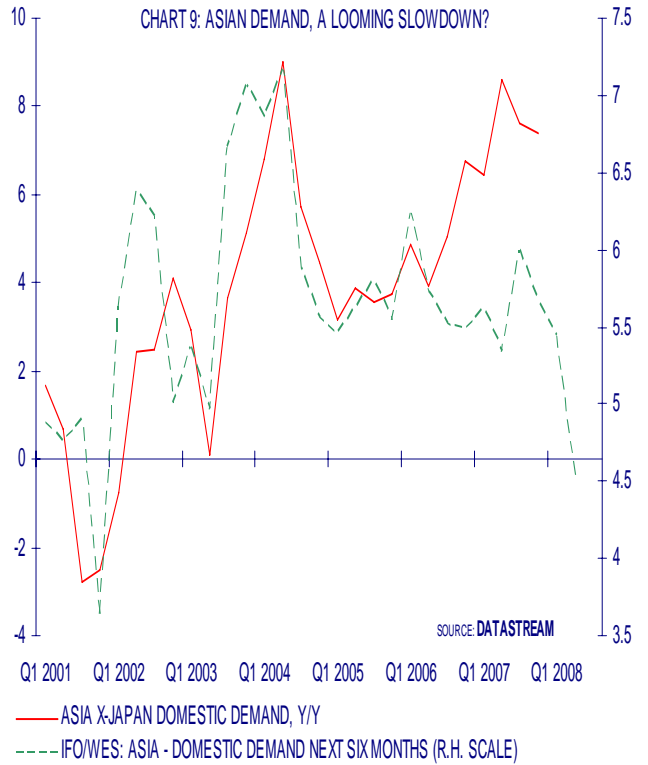
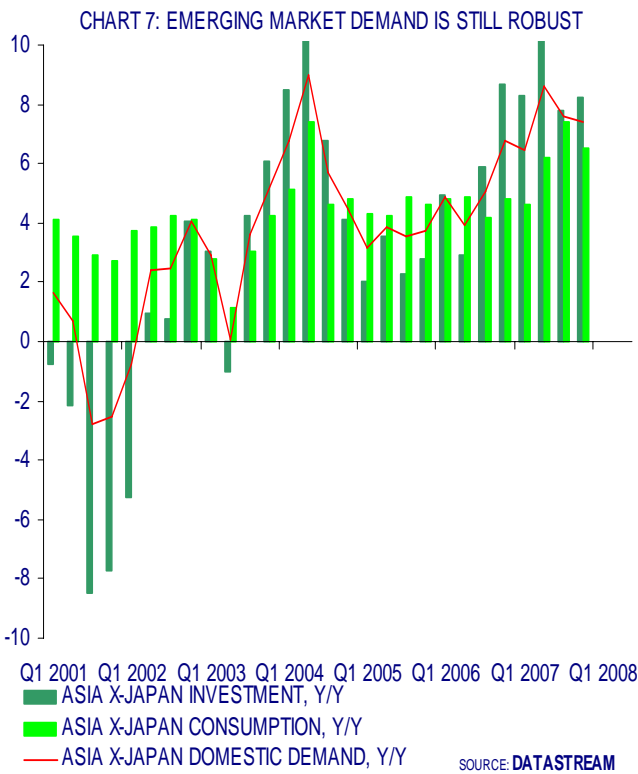
There has been a growing amount of survey data in emerging economies that has come in weaker in the very recent past. That's not to say that there is a wholesale slowdown underway but it has become increasingly difficult to reconcile trends in surveys and in some commodities markets with real economic data. The German IFO institute's World Economic



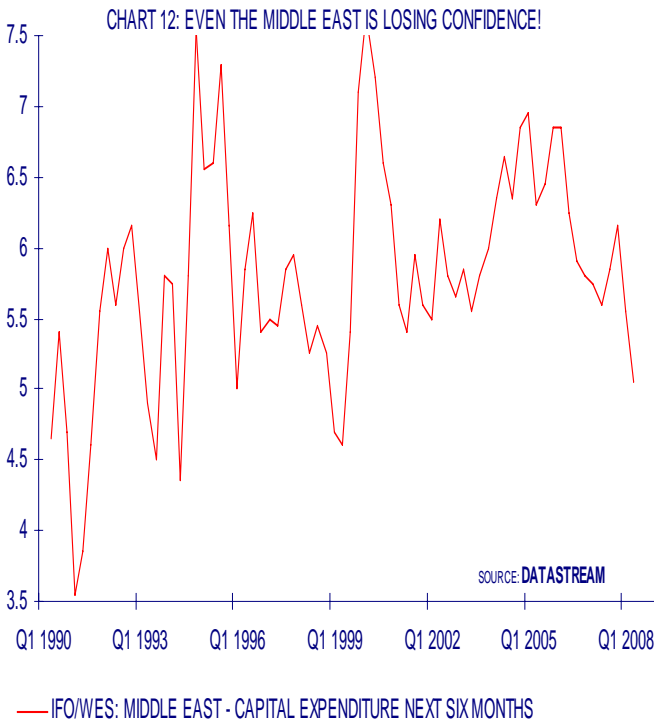
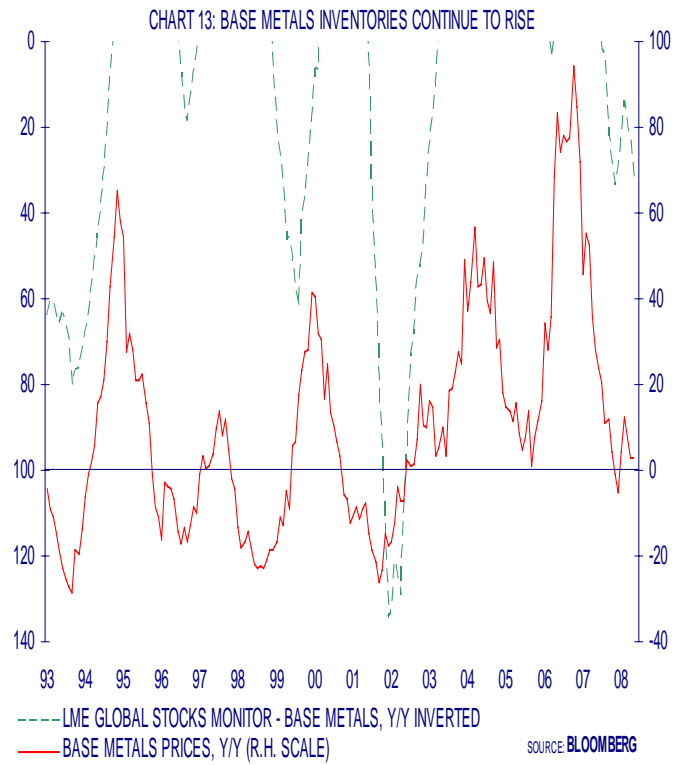
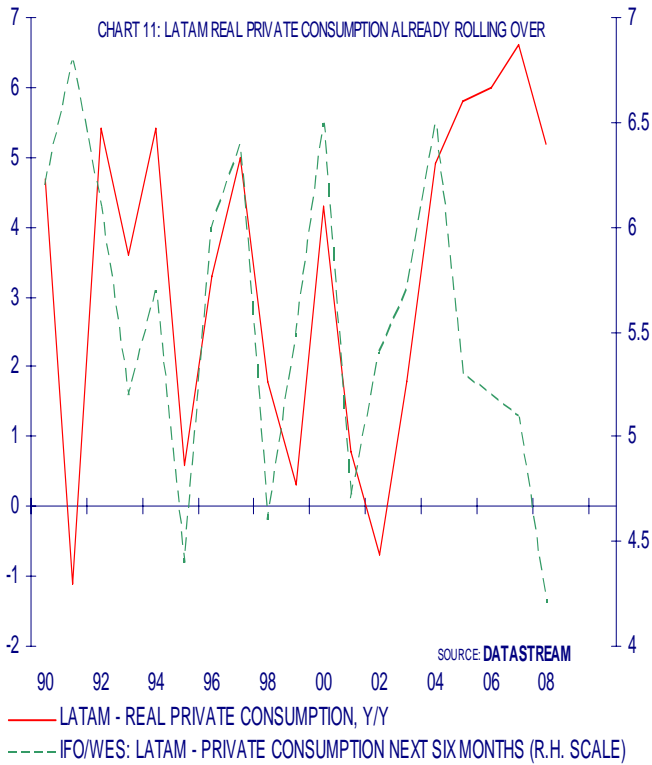


Survey data has traditionally given a good leading indication of the future direction of global economic activity (Chart 8). This same survey data is now pointing to a sharp deceleration in emerging market domestic demand (Charts 9-12). In addition to this, base metals prices have not hit new highs and inventories are in the midst of their first sustained rise since 2001-02, the last economic slowdown and period that

coincided with a metals correction (Chart 13). This trend is important to watch, as a sustained correction in metals prices would be a strong indication that underlying demand has weakened. Finally, Germany and Japan, two major capital goods exporters which have benefited from the emerging market investment boom have seen export growth slow sharply, especially to Asia, whilst Korea's trade balance



has also deteriorated. Taken together, these signals all point to a cyclical slowdown in emerging market demand and it will be key to observe their sustainability.



### Conclusions

Probably being in a secular uptrend, emerging market demand appears to be going through the early stages of a cyclical pullback. The key indicators to watch for confirmation of this slowdown are: individual countries' leading survey data, metals prices and import data from major capital goods exporters such as Germany, Japan and Korea. If a slowdown is, in fact, underway there are some important implications for global markets:

- The price of crude oil will probably correct as EM demand slows.
- Industrial metals prices are also likely to continue to correct.
- Global inflation should fall back to target as Asian economies push productivity higher and drive down Unit Labour Costs (ULC) which will put downward pressure on global ULC's. (Note: US ULC growth has already fallen sharply.)
- There may also be a cyclical pullback in demand for meat in emerging economies as per-capita income growth slows. This would add to an already robust supply response in agriculture potentially leading to sharp falls in global food

prices. (Note: we already expect an easing in agricultural price inflation due to the boost in agricultural production in 2007 and so far this year.)

- EM bourses with heavy weightings in commodities and other commodity-heavy equity markets may underperform as demand for commodities becomes less inelastic and the strong pricing power commodity producers have enjoyed begins to erode.

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