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The Occasional View

GDP Weights and Portfolio Allocation—Update

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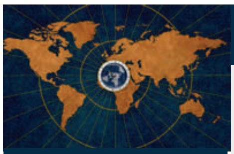
November 2010 Issue No. 38



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Recent data reaffirm that the structure of the world economy is changing fast. This can best be expressed by countries' shares in world gross domestic product (GDP). The faster growing countries naturally gain shares while the slower ones are losing shares in world GDP. Investors therefore need to look closely at whether their investment portfolios remain aligned with the world economy to capture actual and potential future investment opportunities.

GDP measures all economic transactions in a country normally during a one-year period at market prices. The bigger the economy therefore the bigger GDP, that is from the demand side, consumption, investment and net export flows. GDP therefore provides a good basis for measuring investment opportunities. The share in world GDP then provides a good approximation of how investment opportunities on average develop relative to the world average. This also hints at countries economic fundamentals: Countries with strong fundamentals, i.e. low debt and low inflation, are more likely to offer attractive conditions for economic activities. The rise of emerging markets remains the most important development in terms of world GDP:

- Emerging markets represent 37 percent of world GDP at market prices up from 28 percent in 2005. Expected persistent strong GDP growth put emerging markets' share of world GDP at 43 percent in 2015. This makes the aggregate of emerging markets a larger share of world GDP than the European Union of 15 countries (pre-2004) or the U.S. Linear projections indicate that emerging markets would be half of world GDP by 2020.
- China has emerged as the dominant and fastest growing large emerging market. GDP is projected to represent 12 percent in 2015, more than half of U.S. GDP. Emerging markets though is not only about China. The share of world GDP of emerging markets excluding China is 28 percent and projected to increase to 31 percent by 2015. Yet, economic activity is fairly concentrated with the largest 5 economies representing about 50 percent and the largest 10, 65 percent of emerging markets GDP in 2010.
- Advanced economies are set to continue to decline relative to the rest of the world. The share of the EU of 15 has declined from 29 percent in 2005 to 24 percent in 2010 and is projected to fall to 21 percent by 2015. The share of world GDP of the U.S. and Japan are also projected to fall to 22 percent and 8 percent by 2015.

Purchasing power parity (PPP) rather than market prices may provide a better estimate on actual underlying economic transactions in a country. Market prices normally attach very low values for non-tradable goods and in particular services. GDP at market prices therefore tends to underestimate economic activities in particular in emerging markets (a haircut in Thailand costs less than in Germany). To measure economic activity across countries on a comparable price basis, PPP is therefore the better measure. Convergence between GDP at PPP and market prices will imply convergence of relative price levels. This discrepancy will also be supportive of currency appreciation where GDP at PPP is higher than GDP at market prices. At PPP, the GDP of emerging markets of world GDP in 2010 is 53 percent and projected to be 57 percent by 2015.

Changes in the world economy are occurring rapidly and will see an increase of the share of emerging markets in world GDP by 15 percentage points within 10 years between 2005 and 2015. Most investors by any meaningful economic measure continue to be substantially underweight emerging markets. This is because investment portfolios are typically being allocated on the basis of market capitalisation. Until recently, this may have provided a good enough proxy for investment opportunities. However, the increasing asymmetry between market capitalisation and GDP in particular with regard to fixed-income suggests that this is no longer the case. The weighting of investment portfolios by GDP rather than market capitalisation therefore provides a more meaningful approach to seek exposure to the sources of growth of the world economy.[1/] Investors will therefore need to reassess continuously whether their conventional guides to portfolio allocation remain valid.

[1/] See also The Emerging View, issue no. 57, June 2009.

Table. Gross domestic product

40 largest emerging markets in 2010

Share of world GDP at market prices, in percent†

	2005	2010‡	2015
1 China	5.0	9.3	12.2
2 Brazil	2.0	3.3	3.4
3 Russia	1.7	2.4	3.1
4 India	1.8	2.3	2.9
5 Mexico	1.9	1.6	1.6
6 Korea	1.9	1.6	1.7
7 Turkey	1.1	1.2	1.3
8 Indonesia	0.6	1.1	1.4
9 Poland	0.7	0.7	0.7
10 Saudi Arabia	0.7	0.7	0.8
11 Taiwan*	0.8	0.7	0.8
12 South Africa	0.5	0.6	0.6
13 Argentina	0.4	0.6	0.5
14 Iran	0.4	0.5	0.5
15 Thailand	0.4	0.5	0.5
16 Venezuela	0.3	0.5	0.4
17 Colombia	0.3	0.5	0.5
18 UAE	0.3	0.4	0.4
19 Hong Kong SAR	0.4	0.4	0.4
20 Malaysia	0.3	0.4	0.4
21 Singapore	0.3	0.4	0.3
22 Egypt	0.2	0.4	0.4
23 Nigeria	0.2	0.3	0.4
24 Israel	0.3	0.3	0.3
25 Chile	0.3	0.3	0.4
26 Czech Republic	0.3	0.3	0.4
27 Philippines	0.2	0.3	0.3
28 Pakistan	0.2	0.3	0.3
29 Algeria	0.2	0.3	0.3
30 Romania	0.2	0.3	0.3
31 Peru	0.2	0.2	0.3
32 Ukraine	0.2	0.2	0.2
33 Hungary	0.2	0.2	0.2
34 Kazakhstan	0.1	0.2	0.3
35 Qatar	0.1	0.2	0.3
36 Kuwait	0.2	0.2	0.2
37 Bangladesh	0.1	0.2	0.2
38 Vietnam	0.1	0.2	0.2
39 Morocco	0.1	0.1	0.2
40 Slovak Republic	0.1	0.1	0.1
Sum	25.3	34.1	39.6
Emerging markets	27.9	37.4	43.3
EU15	28.5	24.0	21.1
US	27.8	23.6	22.0
Japan	10.0	8.7	8.0

Source: IMF. †WEO October 2010. Ashmore calculation. ‡ ranked by 2010 share. * Province of China.

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