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## *It's All About Jobs*

*By Clark Winter*

The year just ended was a great one for many emerging market equities and national stock markets. As many nations accelerated their march down the path of reform, and as emerging market companies became ever better at competing in both local and world markets, they were rewarded with rising earnings and rising share prices. But what is to be celebrated in 2006 becomes something of a cautionary tale in 2007, for investors, corporate leaders and national decision makers. This year, in fact, may become one of reckoning around the world for many who are now confidently sailing along, certain that they are moving in just the right direction.

Here is our reasoning: Much of the upward movement in emerging market stocks over the past several years can be accounted for by a couple of factors that tend to favor financial wizardry. Selling off state-owned industries to private owners, for example, has the benefit of both lowering national debt and pouring money into national coffers that can then be spent on infrastructure. The result has been a rise in debt quality around the world, and, as emerging market debt ratings have improved, an improvement in national accounts, a virtuous cycle that, looking at tightening spreads between US Treasury's and EM debt, is nearing an

end. There are still nations that have yet more to benefit from falling interest rates, but those are smaller and more peripheral than the major emerging markets—Brazil, Russia, China and India, to name four.

Moreover, many emerging market stocks have been the beneficiaries of this cheap money, having used eased access to the credit markets to go on a capital-spending binge. There is now overcapacity in several industries, such as steel and autos, and even a modest slowdown in the global economy, which has been widely predicted, could have an enormous ripple effect. Many companies will have more than sufficient reserves to cover their debt costs – we don't expect many global bankruptcies – but slimmer profit margins will hurt two ways. First, they will leave less money available for market-share building, critical in a global environment that is growing ever more competitive. Second, given the growth of the past five years, investors are becoming more focused on the future quality of earnings. The pendulum is beginning to swing back from geopolitics to economics, and smart investors are both taking a little bit of their money off the table for re-investment elsewhere, and becoming sharper-eyed in their examination of corporate balance sheets, demanding that emerging market companies adhere to the same

performance benchmarks as their more developed brethren.

None of this need cause any corporate manager to lose much sleep, but the sum of all of these changes could cause national leaders in emerging nations many a worry. The reason can be summed up in a single word: jobs. Over the past five years, GDP growth has not kept pace in most emerging nations with stock market performance, and as a result, job growth has been anemic, or worse. Back in April 2005, the Financial Times' nonpareil economics writer Martin Wolf noted that it was not a wonder that China was growing so fast, but a puzzle why it wasn't growing faster. The world looks at China's near 10% annual GDP growth rate and is breathless in its admiration; Wolf notes that over the same period of their development, South Korea, Taiwan and Japan actually grew at a faster pace.

Pick up any newspaper and there is at least a story a day about the failure of emerging nations to provide jobs for their increasingly well-trained workforces. China sends four million college graduates into the workforce every year, but there are jobs for no more than a million of them. India produces more than 400,000 engineers a year, but there are jobs for perhaps 75,000. Brazil and Russia have similar problems, and the fact that about one in seven illegal

immigrants coming into the US from Mexico has a college degree tells all you need to know about that nation's ability to create new jobs for its best and brightest, let alone for the rest of the population. Indeed, while the world looks at the immigration problem as a developed nation conundrum—how do Europe and the US absorb so many newcomers who are so culturally diverse—the real problem is that many emerging nation leaders still view migration as a safety valve that lets off pressure on them to solve their own growth and jobs problem.

As the immigration problem begins to reach a decision point – the issue will be tackled in the US Congress this year, and will be *the* topic in this April's presidential elections in France—emerging nations are going to be confronted with their policy failures in ways that they have not been over the past five years. Already, in nations from China to Mexico to Thailand, street demonstrations are beginning to call leaders to account over the jobs issue. How they will create solutions at exactly the time when the easy money days are drawing to a close will be critical to determining market behavior *and* global stability in the coming year. In every problem of this magnitude there are many opportunities. It will be up to leaders everywhere to find them. ■