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The Emerging Markets Growth Story: Evolving but Intact

After a volatile and difficult year for emerging markets (EMs), the negative news flow has continued in 2014 as pundits decry the end of the EM growth story. Often the media paints the EMs with a broad brush, recently suggesting that any one of a number of factors—including slowdown in China, shadow banking, the Argentine peso devaluation, weakness in the Turkish lira or South African rand—could spiral into systemic contagion. While these are all risk factors that warrant close attention, we believe there are also misperceptions within the market about the EM growth story. We continue to see longer-term opportunities amid these misperceptions and believe that our clients can benefit from the active management we provide through volatile periods.

During these recent sell-offs, strong businesses have been sold off alongside lesser companies. We have used the downturns to add to investments in companies with attractive fundamentals. As we move further along in this adjustment period, we believe our portfolios are well positioned to benefit from an eventual EM recovery.

In this commentary, we examine some of the key issues and misconceptions shaping the markets. We also explain why the current EM environment is especially well suited for our active investment style.

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As a result of political or economic instability in foreign countries, there can be special risks associated with investing in foreign securities, including fluctuations in currency exchange rates, increased price volatility and difficulty obtaining information. In addition, emerging markets may present additional risk due to potential for greater economic and political instability in less developed countries.

We believe the market's misunderstanding of the EM growth story will ultimately allow our clients to benefit from the active management that we provide through volatile periods.

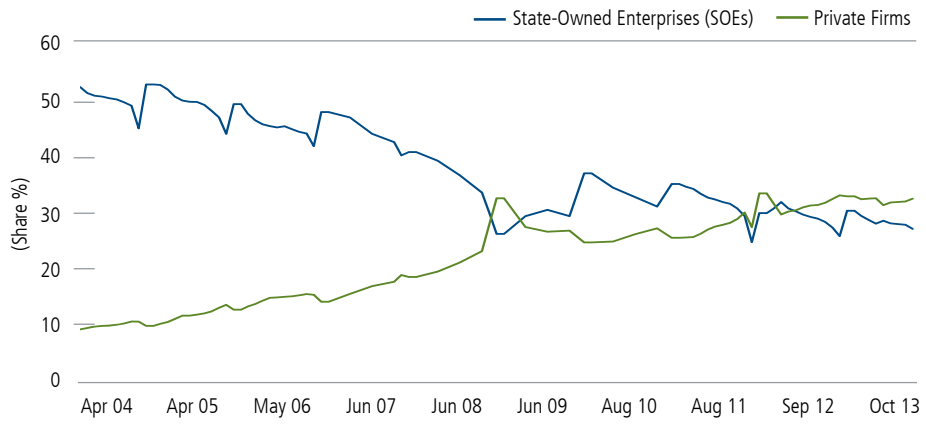
China: A Transition to Private Sector Growth Fuels Opportunity

Many of the EM macro discussions have centered around China, given the size of its economy and its strong ties with many ASEAN economies.[1] These discussions often reflect misconceptions, including that a slowdown in China's economic growth is a negative. In our view, the actions that China is taking to manage its growth as it moves to a more market-based economy are positive, and support our bullish outlook over the medium term.

As China transitions from an economy focused on the growth of public entities to one focused on private enterprise, we believe it is logical for the government to try to slow credit growth to public entities and more importantly, to ensure that risk is appropriately priced. Transitioning such a large economy to a freer-market system is a long-term endeavor, but we are encouraged by the progress China has made so far. For example, as Figure 1 illustrates, privately owned industrial firms are taking a bigger piece of the profit pie. If the publicly supported economy is contracting but the overall economy looks positioned to grow at about 6% to 7% over the medium term, this implies that the private-sector companies in which we are investing are participating in an economy capable of growing faster than 6% to 7%.

FIGURE 1. CHINA'S EXPANDING PRIVATE SECTOR: A CATALYST FOR LONG-TERM GROWTH

SHARE OF TOTAL, LARGER-FIRM INDUSTRIAL PROFITS BY OWNERSHIP



Source: CLSA, "The Plenum Impact, How to think about China," December 2013, Andy Rothman

Investors' heightened focus on the recent Shibor rate[2] spike and the potential for default within the Chinese banking system also makes sense. So far, the issues in shadow banking have been readily contained, but pressure could grow and we are closely monitoring near- and longer-term risks. As I discussed in my recent blog, "Casting Light on China's Banking System," the uncertainties surrounding shadow banking's less-regulated trusts and wealth management projects are by no means insignificant. The system is complex, and managing liquidity while slowing credit growth will be a delicate balancing act. But here too, investors may be overlooking factors that could mitigate the potential for systemic risk, at least in the nearer term. Unlike the U.S., China's financial system is far more closed in nature. Also, we are encouraged by the government's commitment to limiting credit growth and its recent efforts to telegraph the risks of shadow banking to investors. Still, although we are cautiously hopeful that the Chinese government can manage the potential for systemic risk in the financial system, we believe greater caution is warranted in regard to financial sector investments.

Among the EMs, some countries are clearly in far weaker positions to weather a rising interest rate environment.

Instead, we have used recent corrections to increase our allocations to industries and companies exposed to the growth of China's private sector. Although often overlooked, there is significant innovation in the Chinese technology sector. One industry we're favoring is the Chinese internet industry, where we see innovative companies with a keen understanding of how to capitalize on secular and demographic trends. These companies also benefit from having limited competition from state-owned enterprises.

For example, we have identified internet companies that create solutions specifically tailored to Chinese consumers and businesses. During a recent trip to China, our technology analyst met with customers utilizing a software created by a leading Chinese company that is little known in the U.S. As customers described the value proposition this company provided to businesses and customers, the feedback was overwhelmingly positive. The company understands the Chinese consumer and has been able to develop products and services catered toward their specific needs. Moroever, it enjoys a competitive advantage due to the government's removal of Google and the blocking of some U.S. sites.

Argentine Devaluation: An Unlikely Catalyst for Contagion

Another common misconception in the market is that the recent devaluation of the Argentine peso will spark a repeat of the Asian financial crisis, when the devaluation of the Thai baht triggered a contagion effect throughout Asia. As investors who have followed emerging and frontier markets in recent decades, we view Argentina and Venezuela as not being indicative of the broader EM universe, in that both have restricted currencies and capital controls.

Among the EMs, some countries are clearly in far weaker positions to weather a rising interest rate environment. The so-called Fragile Five—India, Brazil, South Africa, Indonesia and Turkey—are among the EMs that have both current account deficits and fiscal deficits. Together, they represent nearly a quarter of EM GDP and more than 12% of global GDP.[3] While this is not an insignificant contribution to the global economy, these five countries have seen their currencies

FIGURE 2. 1997 VS. 2014: IMPACT OF CURRENCY DEVALUATION

In 1997, high levels of foreign-denominated debt led to defaults and the collapse of the baht and other Asian currencies. In 2014, we believe the risks of a similar contagion are lower because the market has effectively devalued currencies, which can help bring current account deficits into balance.

EXPORTS OF GOODS AND SERVICES (% OF GDP)

		1995	1996	1997	1998	1999	2010	2011	2012	% Δ FROM INITIAL YR
ASIAN CRISIS	Thailand	41.6	39.1	48.3	58.0	56.5	66.7	71.4	N/A	71.7%
ASIAN CRISIS	Malaysia	94.1	91.6	93.3	115.7	121.3	93.7	91.6	87.5	-7.0%
ASIAN CRISIS / FRAGILE 5	Indonesia	26.3	25.8	27.9	53.0	35.5	24.6	26.3	24.3	-7.8%
FRAGILE 5	India	11.0	10.5	10.8	11.2	11.7	21.9	23.9	23.8	117.2%
FRAGILE 5	Brazil	7.3	6.6	6.8	6.9	9.4	10.9	11.9	12.6	73.0%
FRAGILE 5	South Africa	22.8	24.7	24.6	25.7	25.3	27.4	29.3	28.3	24.1%
FRAGILE 5	Turkey	19.9	21.5	24.6	21.3	19.4	21.2	24.0	26.4	32.9%

CURRENT ACCOUNT (% OF GDP)

		1995	1996	1997	1998	1999	2010	2011	2012	2013	% Δ FROM INITIAL YR
ASIAN CRISIS	Thailand	-8.1	-8.1	-2.0	12.7	10.1	3.1	1.2	-0.4	-0.8	-90.0%
ASIAN CRISIS	Malaysia	-9.7	-4.4	-5.9	13.2	15.9	10.9	11.6	6.1	3.7	-138.1%
ASIAN CRISIS / FRAGILE 5	Indonesia	-3.2	-3.4	-2.3	4.3	4.1	0.7	0.2	-2.7	-3.5	9.2%
FRAGILE 5	India	-1.5	-1.5	-0.7	-1.6	-0.7	-3.2	-3.3	-4.9	-3.6	143.3%
FRAGILE 5	Brazil	-2.4	-2.8	-3.5	-4.0	-4.3	-2.2	-2.1	-2.4	-3.5	44.9%
FRAGILE 5	South Africa	-1.7	-1.2	-1.5	-1.8	-0.5	-2.8	-3.4	-6.3	-6.2	272.8%
FRAGILE 5	Turkey	-1.0	-1.0	-1.0	0.7	-0.4	-6.2	-9.7	-6.1	-7.1	589.5%

Exports of goods and services (% of GDP): greater global demand for a country's goods and services is preferable for an economy.
Current account (% of GDP): a country is importing more goods than it is exporting, creating negative net sales. Dark green indicates the most favorable relative level, followed by light green, yellow, light orange and dark orange. Red indicates the least favorable level among the countries shown.
Source: Asian Development Bank and IHS

weaken approximately 20% in the past year as the market has effectively depreciated their currencies in an attempt to bring current account deficits into balance. This adjustment reduces the potential for systemic risk and contagion, although contributing to inflationary pressures that central banks must manage. We will be carefully watching to see how the Fragile Five fight inflation without curtailing growth.

> We believe the limitations of passive EM investing will be particularly pronounced in this environment.

There are important differences between today's weaker EM economies and the countries at the center of the Asian financial crisis. EMs today have lower levels of leverage than in 1997 (Figure 3), and they are funding their debts primarily in their local currencies. During the Asian financial crisis, countries' ability to repay foreign-denominated debt came into doubt. This current adjustment process has focused more on the structural reforms that many of these countries need to embark upon to support the next stage in their growth process.

FIGURE 3. 1997 VS. 2014: TOTAL FOREIGN DEBT AS % OF GDP

Today, the Fragile Five have lower levels of foreign debt as a percent of GDP, compared with the late 1990s. In our view, this could mitigate the potential for systemic contagion.

TOTAL FOREIGN DEBT (% OF GDP)

		1995	1996	1997	1998	1999	2010	2011	2012	2013	% Δ FROM INITIAL YR
ASIAN CRISIS	Thailand	59.5	62.0	72.7	93.8	79.0	25.3	23.2	25.2	25.1	-57.8%
ASIAN CRISIS	Malaysia	38.7	39.3	47.1	58.8	53.0	34.4	32.7	33.1	34.0	-12.0%
ASIAN CRISIS / FRAGILE 5	Indonesia	61.5	56.7	63.2	158.7	108.4	27.5	25.2	27.0	28.3	-54.0%
FRAGILE 5	India	25.2	23.7	21.9	22.6	21.3	17.0	17.4	20.1	22.4	-11.0%
FRAGILE 5	Brazil	20.7	21.4	23.0	28.6	41.1	12.0	12.0	13.9	13.9	-32.8%
FRAGILE 5	South Africa					29.4	30.6	29.4	37.0	36.9	25.6%
FRAGILE 5	Turkey					41.3	39.9	39.3	43.0	45.6	10.5%

Total Foreign Debt (% of GDP): a greater debt burden financed externally places additional strain on the economy. Color coding indicates the relative vulnerability of a given country to its foreign debt burden. Dark green indicates a lesser burden, followed by light green yellow and orange. Red indicates the highest relative level of vulnerability to a foreign debt burden.

Source: IHS

While we are currently underweight the twin deficit countries, we intend to build exposure opportunistically as countries improve their fiscal situations and undertake positive structural reforms. We expect this progress to be staggered, as economies resume their growth trajectories at different rates and times. This provides considerable opportunities for active management to add value.

The decades of China's growth lifting all boats are behind us.

FIGURE 4. PASSIVE STRATEGIES OVERLOOK SECULAR OPPORTUNITIES AND RISKS

A strategy that mirrors the MSCI Emerging Market Index may be vulnerable to the higher levels of risk we see in financials, energy and commodities, while missing out on the opportunities in the consumer space and technology.

MSCI EMERGING MARKET INDEX EXPOSURE AS OF 12/31/13

	CHINA	BRAZIL	RUSSIA
Consumer Discretionary	1.0%	0.5%	0.0%
Consumer Staples	1.2	1.8	0.4
Financials	7.4	3.1	1.9
Health Care	0.3	0.1	0.0
Industrials	1.3	0.5	0.3
Technology	2.3	0.3	0.0
Energy	2.7	1.5	0.8
Materials	0.6	1.9	0.8
Telecom	2.0	0.3	1.0
Utilities	0.8	0.5	0.0
Total	**19.5%**	**10.6%**	**7.3%**

Weighting does not reflect significant magnitude of Chinese consumption play

Passive strategies: high exposure to financial sector risks

We see significant opportunity in the Chinese technology sector, more than would be reflected in a market weight

Commodities are susceptible to tapering and modest growth in China

In our view, market weights to Brazil and Russia may be excessively risky

Source: MSCI

In contrast, we believe the limitations of passive EM investing will be particularly pronounced in this environment because passive strategies cannot address the changing risk/reward landscape, leading to suboptimal country and sector positions (Figure 4). For example, a passive strategy would miss much of the Chinese consumption play that we believe will drive growth opportunity. A passive strategy would also include a heavier allocation to the Chinese financials sector than we believe is prudent. Similarly, passive exposure to Brazil and Russia would emphasize the financials sector, again a source of concern for us, as well as commodities, where we believe companies are susceptible to tapering and more modest growth in China.

We Are Well Positioned for this Environment

All emerging markets are not equal and the decades of China's growth lifting all boats are behind us. Going forward, we believe individual country and company growth stories will determine future value. Just as we evaluate each company based on its fundamentals, competitive positioning, management team, growth prospects, and catalysts, we analyze the macro environment of individual EM economies, including their levels of economic freedom. While we have identified bottom-up growth opportunities that we expect to do well regardless of the macro headwinds, we also understand that positive tailwinds, whether cyclical or secular, can help these companies outperform for an extended period.

We have recently written several posts on some of our more favored economies, with the common theme being these markets are moving toward a more open structure that will permit the flow of capital to the most effective uses. These initiatives include infrastructure investments, as well as labor, education, and banking sector reforms. Such reforms can have a long-lasting impact on sustainable economic growth. For example, in Mexico, President Nieto has focused reforms in education, labor, the financial system and the energy sector—all critical areas for businesses deciding where to allocate capital. The broad scope of his "Pact for Mexico" includes privatization of the energy sector and improvements to lending rights and labor relations.

Conclusion

We continue to focus on the risks of EM investing but see significant growth potential in many markets. We can draw similarities between the EMs today and the euro zone in 2012, when individual countries faced a variety of headwinds but as time progressed, the removal of tail risk ultimately resulted in P/E expansion. While volatility is inherent in EM investing, we expect greater divergence among countries and companies in 2014. In this next chapter of the EM growth story, active management will be particularly important.

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Nick Niziolek is a Senior Vice President and a Co-Portfolio Manager on the Calamos Growth/Fixed Income Team. He is also a member of the Investment Committee. He joined the firm in 2005 and has 12 years of industry experience. Prior to joining Calamos, he worked at ABN AMRO and Bank One. He received a B.S. in Finance and an M.B.A. from DePaul University. He is a CFA charterholder and a member of the CFA Institute.

The MSCI Emerging Markets Index is a free float adjusted market capitalization index cited as a measure of the performance of emerging market equities. Indexes are unmanaged, do not reflect fees or expenses and are not available for direct investment.

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[1] ASEAN is an acronym for Association of Southeast Asian Nations, and includes Indonesia, Malaysia, the Philippines, Singapore, Thailand, Vietnam, Laos, Myanmar and Cambodia.

[2] The Shanghai Interbank Offered Rate, or Shibor, is a bank-to-bank lending rate.

[3] Source: IMF

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