The Changing Global Capital Markets

By Kelly Haughton, Noriyuki Oharazawa, Pradeep Velvadapu, and Xin Yan, Ph.D.

Emerging market countries are growing and increasing their share of global equity markets. For example, China, with a population that exceeds 1.3 billion, often is regarded as the world’s fastest-growing large economy. According to the International Monetary Fund’s October 2007 World Economic Outlook, the global economy expanded vigorously in the first half of 2007, with growth above 5 percent. China’s economy, by comparison, expanded by 11.5 percent. Both India and Russia also grew strongly. These three countries, the IMF says, accounted for one-half of global growth in the past year.1 An emerging global player in the Americas is Brazil. Collectively known as BRIC—for Brazil, Russia, India, and China—these four countries are becoming potent global economic forces as they bring the dynamism of capitalism to bear on their economies.

Global Growth

Global economic growth is reflected in the increase of market capitalization, data that Russell Investments gathers for its global indexes. At a fundamental level, market capitalization, or market cap, is the value of a corporation determined by multiplying the number of outstanding shares by the current market price of a share. In calculating market capitalization, Russell adjusts the capitalization of individual securities to reflect only those shares available to the public, known as float. Since 2001, global float-adjusted market capitalization has grown at an annualized rate of 10.7 percent, from $21.6 trillion in 2001 to $38.4 trillion in 2007 (see figure 1). However, in BRIC countries market capitalization has grown at a remarkable six-year annualized rate of 30.5 percent vs. the U.S. rate of 6.2 percent.

Developed Market Cap and Emerging Market Cap

An analysis of float-adjusted market capitalization reveals that the market cap of emerging market countries has been growing at a faster rate than that of developed countries. Quite literally, countries in emerging markets are taking away market share from countries in developed markets, as measured by market capitalization (see figure 2).

- Thirty-seven countries constitute the emerging market segment, while 26 countries make up the developed market. Of the emerging market countries, Brazil, Russia, India, and China are growing at a faster rate not only among emerging market countries, but also among developed countries such as Japan and the United States.
- The float-adjusted market capitalization of emerging markets as a proportion of global market cap grew from 3.5 percent in 2001 to 10.2 percent in 2007, a nearly 300-percent increase.
- In real dollars, as of June 2007, the float-adjusted global market cap totaled $38.4 trillion, with $34.5 trillion in developed markets and $3.9 trillion in emerging markets. That compares to $29.9 trillion and $752 billion, respectively, in July 2001, which amounts to a five-fold increase in six years in market cap in emerging markets.
Developed and Emerging Markets
Weighted by Large- and Small-Cap Companies

Worldwide, large-cap companies make up about 90 percent of the global market cap; small-cap companies account for about 10 percent. Despite their dominant market share, the actual number of large-cap companies is small relative to the number of small-cap companies. Globally, as of June 2007, Russell Indexes tracked about 3,155 large-cap securities and 7,519 small-cap ones.

- There has been substantial growth in the percentage and size of the world’s largest companies in emerging markets. Globally, emerging markets’ share of the large-cap universe has increased from 2.5 percent in 2001 to 8.9 percent in 2007, more than a 350-percent increase (see figure 3). This primarily is due to government denationalization and a significant increase in the number of initial public offerings (IPOs) in the emerging market arena, as well as large companies growing larger.
- In dollars, the float-adjusted capitalization of large-cap companies in developed markets grew 61 percent, from $19.3 trillion in 2001 to $31.1 trillion in 2007. In comparison, large-cap companies in emerging markets grew 484 percent, from $514 billion in 2001 to $3 trillion in 2007.
- BRIC countries are leading the growth in large-cap companies in emerging markets (see figure 4).
- The number and market share of small-cap companies in emerging markets is also growing, though not as much as large cap. Small cap’s proportion in emerging markets increased from 12.9 percent in 2001 to 20.2 percent in 2007, a 156-percent increase (see figure 5).

U.S. Market Cap and Non-U.S. Market Cap

Overall global market cap nearly doubled between 2001 and 2007. However, U.S. market cap grew at a much slower rate than that of all other countries combined (six-year annualized rate of 6.2 percent for the United States vs. 15.5 percent for global excluding the United States). This reflects the growing importance of emerging market economies at a time when U.S. economic influence, while still important, is declining.

- In a reversal of fortunes, the size of U.S. market cap as a proportion of global market cap declined between 2001 and 2007 from 57 percent to 44 percent while all other countries increased from 43 percent to 56 percent.
- In 2007, this represented a dollar amount of $16.8 trillion for U.S. market cap vs. $21.6 trillion for non-U.S. market cap.

BRIC Market Cap and Emerging Market Cap (Excluding BRIC Market Cap)

Comparing just BRIC to the other 33 emerging market countries, we see that these four countries have grown at a faster rate than their emerging market colleagues (six-year annualized rate of 30.5 percent vs. 20.9 percent). Four factors account for this rapid growth: a high number of initial public offerings (IPOs), a well-established global footprint, individual investors purchasing securities in record numbers (especially in China), and emerging market dominance by BRIC companies (see table 1).
• As noted previously, the majority of BRIC’s growth relative to other emerging market countries is due to the growth of large-cap companies. Small cap has played a minor role.

• Large-cap companies in Brazil, Russia, India, and China have grown from a combined market cap of $188 billion in 2001 to $1.6 trillion in 2007, accounting for 41 percent of the total emerging market cap.

• BRIC companies account for 21 of the largest 25 securities in emerging markets ranked by company market cap (not float-adjusted) as of June 25, 2007. These companies either began in the Russell Global Index in 2001 or joined it before 2007. Twelve began at the mid-cap tier and then “graduated” to large-cap during that time period.

• Many of the companies are familiar brands, such as Petrobras, Vale do Rio Doce, Banco Bradesco, and Banco Itaú in Brazil; Gazprom, Sberbank, and Unified Energy System in Russia; Reliance Industries, and Oil & Natural Gas Corporation in India; and China Mobile, China Petroleum, China Life Insurance, Bank of Communications, Ping An Insurance, and China Shenhua Energy Company in China.

• Though BRIC’s proportion of global small-cap companies was fairly constant in 2001–2004 at about 20 percent, in the past several years the proportion has been increasing: 21.2 percent in 2005, 25 percent in 2006, and 26.5 percent in 2007. There appears to be potential for more growth in small cap as BRIC economies continue to expand.

Japan Market Cap and Asia, Excluding Japan Market Cap

Just as U.S. securities are shrinking as a proportion of the world’s capital markets, Japanese securities are shrinking as a proportion of the overall Asian market.

• In 2001, Japan’s market capitalization made up 70 percent of the 13-country Asian market. By 2007, it had fallen to just 50 percent. Japan’s market cap expanded during the six-year period, but at a much slower rate than other Asian countries during that same time frame, causing it to lose market share.

• The growth of India and China accounts in part for why Japan’s overall market presence has shrunk.

• Demographics in Japan, including a declining birth rate, aging population, and little immigration due to government policy, is constraining population growth and is likely contributing to slower economic growth.

Japan Market Cap and Greater China Market Cap

In 2007, the combined market capitalization of companies that trade on stock exchanges within what some have called “Greater China” surpassed the market capitalization of companies traded on Japanese exchanges. This change in position occurred in the second quarter of 2007, and the gap continues to widen. The combined total for Greater China at the end of May 2007 equaled $5.6 trillion while the number for Japan was just below $5 trillion.

Primary drivers behind China’s increase in market capitalization are extraordinary returns for the Chinese A share market during the first five months of 2007 and a large number of initial public offerings. Fifty IPOs raised more than $15.5 billion during the second quarter of 2007 alone,
closely matching the $15.7 billion raised by IPOs in the United States during the same period.

About 20 percent of Greater China’s market capitalization is unlisted and is held mostly by the Chinese government, insiders, and other strategic holders of a company’s shares. For example, PetroChina, which ranks as the largest company in the Russell Emerging Markets Index, has more than 90 percent of its market capitalization, representing about $200 billion, unavailable to investors.

**Sector Weights**

From six-year annualized returns, each of nine sectors tracked by Russell in emerging markets is out-performing its counterpart in developed markets.

Further, comparing 2001 sector weights with 2007 sector weights, it is clear that the sectors responsible for driving growth in emerging markets are those most associated with infrastructure development, such as materials and processing, utilities, energy, and technology. Table 2 shows the growth of float-adjusted market capitalization, by weight, of nine sectors in emerging markets between 2001 and 2007. The data reflects a June-to-June time period, which is when Russell annually reconstitutes its indexes.

For example, emerging markets accounted for 6.8 percent of the market capitalization of the global materials and processing sector in 2001 but grew to account for 17.4 percent of that sector in 2007. Likewise, the market capitalization of the technology, energy, and utility sectors in emerging countries all grew to more than 10 percent of the global market capitalization for their respective sectors in 2007.

Prime examples of this growth include technology stocks such as Infosys Technology (India), energy stocks such as Gazprom (Russia), materials and processing stocks such as Reliance Industries (India), and utilities stocks such as China Mobile (China).

Other sectors, including health care, consumer staples, consumer discretionary, producer durables, and financial services, also are growing in emerging markets, but they are growing more slowly than the four mentioned above. In 2007, they each accounted for less than 10 percent of their respective sector’s global market cap.

**Correlations**

World markets are becoming more interdependent. Events that happen in one part of the world have an impact on other parts—a trend that appears to have increased between 2001 and 2007. Something that happens in Europe affects Japan, which affects the United States.

### TABLE 2: GROWTH IN EMERGING MARKETS LED BY MATERIALS AND PROCESSING SECTORS

<table>
<thead>
<tr>
<th>Sector</th>
<th>2001 Weight</th>
<th>2007 Weight</th>
<th>Companies</th>
<th>Country</th>
</tr>
</thead>
<tbody>
<tr>
<td>Materials &amp; Processing</td>
<td>6.8%</td>
<td>17.4%</td>
<td>Vale Do Rio Doce (VDRD), Reliance Industries</td>
<td>Brazil, India</td>
</tr>
<tr>
<td>Utilities</td>
<td>5.5%</td>
<td>14.3%</td>
<td>China Mobile, America Movil, Bharti Airtel</td>
<td>China, Mexico, India</td>
</tr>
<tr>
<td>Energy</td>
<td>3.9%</td>
<td>13.1%</td>
<td>Gazprom, Petrobras, Petrochina</td>
<td>Russia, Brazil, China</td>
</tr>
<tr>
<td>Technology</td>
<td>5.3%</td>
<td>12.3%</td>
<td>Infosys Technology, Samsung Electronics</td>
<td>India, South Korea</td>
</tr>
<tr>
<td>Financial Services</td>
<td>3.4%</td>
<td>9.6%</td>
<td>Industrial &amp; Commercial Bank of China (ICBC), Kookmin Bank</td>
<td>China, South Korea</td>
</tr>
<tr>
<td>Producer Durables</td>
<td>2.4%</td>
<td>8.8%</td>
<td>Embraer, Bharat Heavy Electronics</td>
<td>Brazil, India</td>
</tr>
<tr>
<td>Consumer Staples</td>
<td>3.1%</td>
<td>6.8%</td>
<td>AMBEV, China Mengniu Dairy</td>
<td>Brazil, China</td>
</tr>
<tr>
<td>Consumer Discretionary</td>
<td>2.1%</td>
<td>6.0%</td>
<td>Hyundai Motor Corp., Naspers</td>
<td>South Korea, South Africa</td>
</tr>
<tr>
<td>Health Care</td>
<td>0.3%</td>
<td>1.6%</td>
<td>KRKA, Ranbaxy Laboratories</td>
<td>Slovenia, India</td>
</tr>
</tbody>
</table>

### TABLE 3: CORRELATIONS GROWING STRONGER BETWEEN DEVELOPED AND EMERGING MARKETS

<table>
<thead>
<tr>
<th>Year</th>
<th>Developed vs. Emerging</th>
<th>Developed LC vs. Emerging LC</th>
<th>Developed SC vs. Emerging SC</th>
</tr>
</thead>
<tbody>
<tr>
<td>2001</td>
<td>0.58</td>
<td>0.59</td>
<td>0.61</td>
</tr>
<tr>
<td>2002</td>
<td>0.53</td>
<td>0.55</td>
<td>0.57</td>
</tr>
<tr>
<td>2003</td>
<td>0.77</td>
<td>0.76</td>
<td>0.75</td>
</tr>
<tr>
<td>2004</td>
<td>0.80</td>
<td>0.81</td>
<td>0.72</td>
</tr>
<tr>
<td>2005</td>
<td>0.86</td>
<td>0.86</td>
<td>0.83</td>
</tr>
<tr>
<td>2006</td>
<td>0.81</td>
<td>0.82</td>
<td>0.72</td>
</tr>
<tr>
<td>2007</td>
<td>0.85</td>
<td>0.86</td>
<td>0.80</td>
</tr>
</tbody>
</table>
One way to demonstrate this trend toward interdependency is through correlation analysis, a statistical measure of the degree to which the movements of two variables are related. High numbers indicate a strong correlation; low numbers indicate a weak correlation.

States, which affects Latin America, which affects Russia, and so forth.

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Investors often seek to diversify their portfolios by investing in securities that are not highly correlated. In other words, they expect that low correlations will protect them when some stocks go down while others are going up. Correlation values below 1 indicate at least some diversification benefit. However, the lower the correlation, the more the benefit.

Table 3 indicates that stocks are becoming more highly correlated and therefore may offer fewer diversification benefits. The trend, however, is not monotonic. Emerging small-cap stocks still have lower correlations with other asset classes and offer diversification benefits, though less so than they did in 2001. Information about small-cap stocks is not as well-known outside the home country, so local investors may be able to take advantage of local information and market timing.

**Conclusion**

The world’s capital markets are becoming increasingly global, and the growth of capital markets in emerging markets is outpacing that in developed ones. While market capitalization is increasing worldwide, it is increasing the fastest in the BRIC countries. The increase is most pronounced among large-cap companies, but it extends to both large- and small-cap and is evident across the nine sectors tracked by Russell. In contrast, the market capitalizations of the historical leaders of capital markets—the United States, the United Kingdom, Japan, and Europe—still are growing but at a slower pace than those in emerging markets. Barring unforeseen political or social events, or natural disasters, we see no evidence of a reversal in the trend of faster growth in emerging markets and slower growth in developed ones.

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