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Emerging markets turmoil: Quit overreacting

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Despite the recent sell-off of emerging market currencies, investors should look at the bigger picture

By Dan Steinbock

FORTUNE – For years, the market mantra was that emerging markets represented future growth. Lately, however, investors have pulled record levels of capital out of economies from Brazil to India. This is an overreaction; too many investors and analysts are focusing on short-term fluctuations rather than keeping their eye on emerging markets' longer-term prospects.

Though the sell-off has eased, emerging market funds experienced massive outflows soaring to more than $33 billion in the 15 weeks before February, according to Morgan Stanley.

Much of the turmoil has been driven by several events, including Argentina's faltering currency crisis, signs that China's economy is slowing down, as well as longstanding political unrest in Turkey, Ukraine, and Thailand. Investors grew risk averse, betting their money instead on advanced economies and ignoring some not-so-good data from the UK and the US. And the U.S. Federal Reserve's move to reduce its massive bond purchases didn't help either; it contributed to a global sell-off.

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Markets, however, eased this week when the world's major economies, including the U.S., pledged at the Group of 20 meeting that its central banks would be "mindful of impacts" of monetary policy settings, although the U.S. did not indicate any change in the Fed's current policy approach.

Nonetheless, if the volatility resurfaces in the near future, it does not indicate that investors are "returning" to the U.S., European or Japanese markets. Rather, it reflects investors' uncertainty in an era when advanced economies muddling their way amidst debt crises and emerging markets remain poorly understood.

Emerging markets are far from equal; they are diverse, and the problem is that investors tend to wrongly clump them together. In most emerging economies, GDP per capita, adjusted to purchasing power, varies from $2000 to $9,000 (China), or even $16,800 (Russia).

South Korea's GDP per capita, at $32,000, is far higher, above even the European Union's average, as well as other developed economies, including Italy and Spain. In Taiwan, GDP per capita is close to $39,000, which is about the same as in Sweden and Germany and higher than in the UK, Japan and France –not your typical emerging markets.

Even some of the most prestigious investment houses neglect these differences and other critical distinctions. The net effect is that they use highly complicated models to generate projections that have dubious value.

A lot of attention has been given to the so-called "fragile five": India, Indonesia, Brazil, Turkey, and South Africa. Markets have focused on the internal challenges of the fragile five, especially fiscal and current account deficits, falling growth, excessive inflation and political uncertainty. What markets have ignored is that the growth potential of emerging economies is affected by very different regional growth conditions, and different levels of economic development.

Moreover, these countries have been affected by economics factors abroad. Due to ties with the U.S., some have been exposed to "hot money" inflows in the past and the Fed's tapering today. Others have been affected by China's reduced growth prospects and the end of the commodity supercycle.

The real question is why the fragile five should be penalized only now, when many have been coping with structural challenges for quite a while.

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Certainly, in the short-term, many face difficult trade-offs, though not necessarily the risk of a full-scale economic crisis. After all, today these economies have sounder banking and financial systems, tolerable debt ratios, flexible exchange rates and large reserves. In the medium- and long-term, they enjoy promising prospects, thanks to solid growth potential.

In the future, emerging economies will drive an increasing share of global growth. But it will not be a smooth ride. The promise of the potential growth is not identical with actual growth. Some countries will gain, others will lose.

However, investors who mistake short-term fluctuations with long-term potential have more to lose.

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