A *SURE* BET

AS GDP GROWTH IN DEVELOPED COUNTRIES CONTINUES AT A LACKLUSTER RATE, ALL EYES ARE TURNING TO THE EAST

BY THEODORE KIM, CFA

Betting on the direction of the market in a one-day to one-month time frame is difficult enough. Yet, many day traders, hedge fund managers, and the vast majority of retail investors do it every day. Undoubtedly, sifting through all of the investible financial instruments to find the next hot outperformer over a decade-long period is more onerous. Still, today analysts are clear about one thing: don't bet that the solid US economic growth and stellar market returns of the past will be repeated anytime soon.

Illustrations: Mike Hodges

"...THE 21st CENTURY WILL BELONG TO CHINA."

JIM ROGERS, CO-FOUNDER OF THE QUANTUM FUND

Despite a modest rebound in US equity markets — the S&P 500 has appreciated in the first 10 months of 2003 by nearly 20 percent — the jury is still out on just how fast and how far any economic recovery will take hold of the public markets. A rebound in employment figures has been the primary driver behind all of the economic recoveries in post-war US history. This time around, the jobless nature of the nascent recovery has led many skeptics to question the strength and longevity of any market rally.

Not only has there been no improvement in the hardest-hit sectors of manufacturing and heavy industry, but the key service sectors — technology, telecom, media, transport, and finance — that turbocharged the bull markets of the past, are still far from any significant rebound in hiring. The millions of high value-added jobs lost over the last three years, and the frenzied consumer-spending binge that those jobs created, will not be recreated anytime soon — at least not inside the United States.

The picture in Europe is hardly rosier. An aging population, declining birth rates, exceedingly rigid labor markets, and growing sentiment toward protectionist trade policies are all aligning to keep pan-European-expected GDP growth rates at rock-bottom levels. On top of flat growth rates, the huge asset-liability mismatch in the European pension sector, much of which is fully state run, is far more ominous than that of the United States.

With projected macroeconomic numbers across the developed world appearing so lackluster, analysts are searching far and wide to find the next great investment theme — and all eyes are turning to the East.

MANDATORY MANDARIN

At a recent presentation to the New York Society of Security Analysts, Jim Rogers, co-founder of the Quantum Fund, author of *Investment Biker* and more recently *Adventure Capitalist: The Ultimate Investor's Road Trip*, summarized the investment trend of the next decade.

Having toured 116 countries in search of new investment angles, Rogers concludes, "The 19th century was the century of England, the 20th century belonged to the US, but the 21st century will belong to China." He is so bullish about China's long-term prospects that he hired a Chinese nanny so his infant daughter could get a head start in learning Mandarin.

For the long run, Rogers thinks China could become a factory to the world, as global production shifts away from developed high-labor-cost markets such as the US and Europe, and moves eastward toward China. Also, with a population of over one billion and a rising standard of living, the Chinese domestic economy will eventually become the world's largest consumer market.

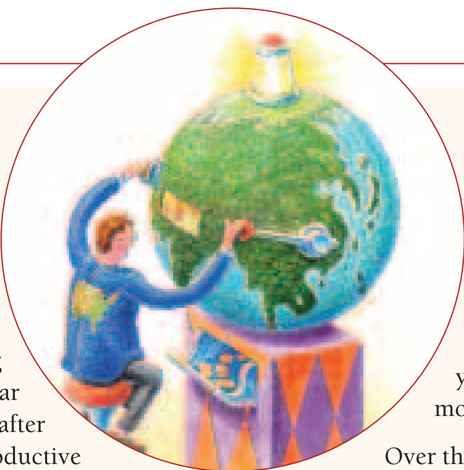
In the short run, however, Rogers feels there will certainly be some serious setbacks. Next year, for instance, he sees the country's economy suffering a major blow due to the effects of the monetary belt-tightening now being put in place to reign in speculative hysteria. "When the Chinese central bank wants to do something, it tends to get it done," he explains.

The near-term prospects of a sharp economic hiccup are also compounded by the dearth of investible Chinese financial instruments. Although Rogers himself owns a select handful of Chinese B shares traded in Shenzhen or Shanghai, his big

BETA AROUND THE GLOBE / 1987–2002

Country	Beta	Country	Beta
Global Beta	1.00	Malaysia	0.87
Europe	0.93	Philippines	0.94
US	0.84	China	0.97
Jordan	0.06	South Africa	0.98
Colombia	0.22	Mexico	1.00
Pakistan	0.37	Turkey	1.04
India	0.43	South Korea	1.13
Chile	0.50	Thailand	1.20
Egypt	0.52	Brazil	1.30
Argentina	0.55	Hungary	1.30
Taiwan	0.79	Poland	1.47
Venezuela	0.79	Russia	2.28
Indonesia	0.82		

Source: Thomson Financial, McKinsey & Company



long-term play involves how the Chinese economy will affect an entirely separate asset class: commodities.

With scarce natural resources of its own, China is buying gigantic amounts of raw materials from across the globe, driving many commodity markets up to five-year highs. “Continued increases in demand after two decades of little investment in productive capacity and steadily decreasing inventory should insure a multi-year bull market despite normal consolidations along the way,” Rogers explains.

Proxy plays on China through direct investment in commodity markets are not the only game in town. Commodity exporting nations, such as Canada and Australia, as well as commodity-producing firms, may also prove to be great long-term bets.

Even apart from increasing Chinese demand for commodities, inflation should also act as another huge driver. For Rogers, far from any widely perceived risks of a deflationary global economy, the commodities markets are perfect vehicles to play what he expects inevitably to be across-the-board inflation. “Everyone who thinks there will be deflation does not understand 21st-century central bank policy. The US Federal Reserve, like other central banks, will debase its currency. Out of 12 or 15 major currencies that I own, I have confidence in none of them. I hoped I could find a currency where I could put all my money, but one does not exist. The others are just less flawed than the US dollar,” he adds.

YOU PAY YOUR MONEY AND TAKE YOUR CHANCES

In addition to Rogers, another big commodities bull pundit is Marc Faber, editor and publisher of the widely followed investment newsletter *Gloom, Boom & Doom Report* and author of the best selling book *Tomorrow’s Gold*. “We are now in the beginning of a major long-term commodities bull market, just as we saw in the 1970s — and also in the equity markets in Japan in the 1980s and the United States in the 1990s,” he claims.

Faber is especially interested in major up-and-coming commodity exporting nations, such as Russia and even Mongolia. Yet, the inherent volatility of emerging markets may mean that investors are in for a rough ride ahead. Accurate timing of short-term cycles is essential. “It is very important that you get into an emerging market when an accident has just happened and they are flat on their back — not when there is euphoria. At the moment, there is just too much China euphoria. The China card has been overplayed already by buyers of Chinese shares and commodity futures,” he cautions.

A number of other Asian markets, widely projected as a hotbed of economic growth over the next decade, may also be in for a short-term, sharp correction. “If you buy Thailand today — one of the best-performing markets over the last year — you could wake up tomorrow morning with a 30 percent loss,” says Faber.

Over the very long run, nonetheless, Faber is confident that emerging markets — Asia in particular — are experiencing just the beginning stages of a major secular uptrend relative to developed markets. “You can certainly call me a bull on Asia,” he adds. “But perhaps it is also accurate to say that I am a huge bear on the United States.”

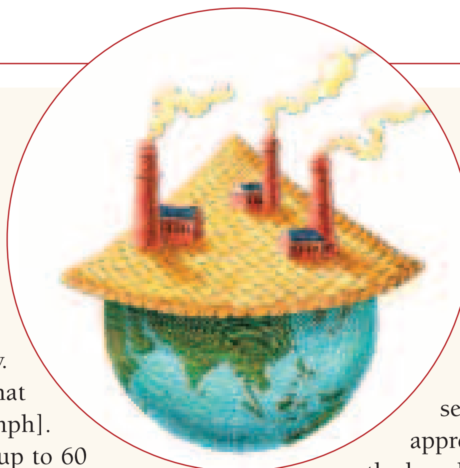
THE BIG PICTURE

On a country-by-country basis, emerging market investing may certainly appear similar to a trip to the roulette table. However, new research indicates that it might be possible to bet on the next big outperformer in East Asia and, at the same time, to hedge other bets contained in a globally diversified portfolio. In an article published in the *Financial Analysts Journal* titled “Emerging Markets: When Are They Worth It?” (March/April 2002), the authors argue that global equity returns over the last 20 years have shown little correlation between emerging and developed capital markets. Simply put, a collapse in an emerging market does not suggest an immediate collapse in a developed market.

Over time, the lack of correlation between the two asset classes suggests that emerging market risk could be diversified away in a global investment portfolio. In addition, in a report produced by McKinsey and Company entitled, “Emerging Markets Aren’t as Risky as You Think,” consultants Marc Goedhart and Peter Haden argue that stock returns over the past 15 years suggest that a wide portfolio of emerging market equities has not been more volatile than an investment in a single US- or Europe-based blue-chip corporate (see global beta chart).

Mohammed El-Erian, managing director at Newport Beach, Calif., USA-based Pacific Investment Management Company LLC (PIMCO), is perhaps one of the world’s most powerful and respected fixed-income fund managers as well as the most established champion of outperformance through emerging market investment — if managed correctly.

El-Erian looks at a decade-long investment in global markets and breaks the time frame into a short-term journey, as opposed to the long-term destination. For the journey, investors are playing highly cyclical forces. The fluidity of the global economy, the need for the United States to fund its current account deficit, and an ever-growing plethora of hot



money hedge funds will result in highly volatile valuations.

Thus, in playing for the destination — a five-year-plus time frame — investors should be well compensated for enduring the peaks and valleys along the way. "Emerging markets are like a car that should be driven at 30 miles per hour [mph]. Sometimes, a tailwind will push the car up to 60 mph. At other times, a head wind will slow the car to 10 mph," El-Erian explains. "The truth is that this is a car that is supposed to be driven at 30 mph, and you should not be fooled into thinking differently."

PIMCO categorizes global emerging markets into three classes. The first class is their anchor group, delivering true and steady returns — albeit with limited upside potential — and includes such advanced emerging economies as Mexico, South Africa, Chile, Hungary, and Poland. The second group, which includes Brazil, Peru, and Ukraine, acts as the "return engine," providing far more upside potential, yet carrying with it a definite degree of increased volatility.

The final PIMCO group, including Argentina, Uruguay, and Venezuela, is the wild card and should be avoided at all costs. Clearly, El-Erian is not so much bullish about the entire universe of emerging markets, but instead focuses on a carefully selected handful of long-term plays. "What is true about the emerging market asset class as a whole is absolutely *not* true for each and every instrument," he cautions.

PIMCO also maintains a crucial distinction between the fundamentals backing a long-term sovereign play, such as increased foreign direct investments, export earnings, and hard currency reserves, as opposed to the numbers backing a corporate play, which often entails a huge degree of personality risk. For instance, El-Erian believes that Russian sovereign debt continues to represent a good buy, despite the significant price appreciation over the last year resulting from the hugely strengthened solvency of the central government. In contrast, he is highly skeptical of any Russian corporate issue, arguing that solidly improving sovereign fundamentals have not really transferred to significantly improved credit quality in the corporate sector.

A further distinction exists between markets that El-Erian sees as actually investible today, such as Brazil and Russia, versus markets that offer huge upside potential but a limited number of investible instruments, such as India and China.

While there are presently few market vehicles to bet on the expected stellar growth rates in India and China, the real play will be in determining how these two giant economies will affect global markets as a whole, particularly as corporate issuers based in G5 countries endure huge competitive pressures on manufacturing and wage costs.

"The China effect in the global economy is enormous. Even a manager focusing exclusively on investment-grade US corporates will realize that these corporates will slowly loose their pricing power," argues El-Erian. "The China factor is so huge, it will affect the entire global investment game across the board."

GLOBAL GDP GROWTH

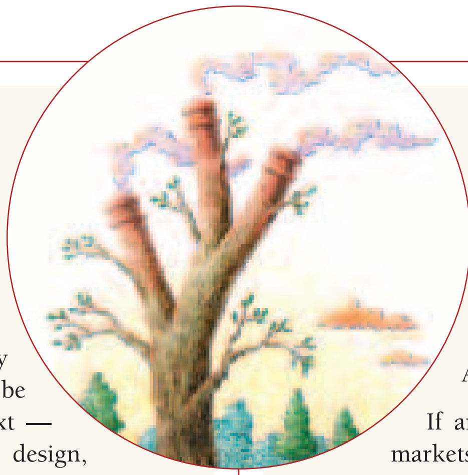
Country-Region	Estimated % 2004 GDP Growth
Global Economy	4.0
Industrial World	3.0
USA	4.4
EMU	2.0
Emerging Europe	4.4
Japan	1.4
Asia ex-Japan	6.0
China	7.8
India	6.0
Latin America	3.6
Brazil	4.4

Source: Morgan Stanley

PLAYING THE NORTH-SOUTH-EAST-WEST ARBITRAGE GAME

While there is huge debate raging as to how to pick exact instruments and trades that will outperform over the next decade, most analysts agree that we are at the beginning stages of a gradual long-term trend where production and services will shift from the developed markets to emerging economies. What is now seen as a temporary jobless recovery may, in the long run, turn into a recovery that never recreates the millions of jobs lost throughout the developed world.

The potentially permanent nature of job losses is not merely in the dying sectors of shoe factories and steel mills, but in high-value-added services as well. In the United States alone, total headcount in the service sector, the largest component of GDP, is virtually unchanged over the past two years — despite the average 5 percent gains experienced over all of the last cyclical recoveries. This puts the US service sector 4.5 million jobs in deficit compared with the expected hiring that would



have occurred in a normal upward business cycle.

One major reason for the absence of job recovery is the shift in traditionally "non-tradable" services to low-cost offshore markets such as India. A huge array of services that once were assumed to be deliverable only in a face-to-face context — including accounting, finance, research, design, engineering, and IT — can now be done at the click of a mouse in Chennai and Mumbai for a tiny fraction of the cost.

Yet, the answer may not be as simple as overweighting emerging markets and underweighting developed markets. According to a recent research report, "Outsourcing, Protectionism, and the Global Labor Arbitrage," issued by Stephen Roach, chief global economist at Morgan Stanley, we may now be facing merely the first round of global labor arbitrage where jobs, income, and security shift away from the developed economies and toward the emerging markets.

"Jobless recoveries could well remain the norm in developed economies for some time," he writes. "The greater the pressures on job and income security, the greater the risk of protectionist responses by the high-labor-cost nations of the industrial world." Roach cites a historic example from 1930 when the US Congress passed the highly protectionist Smoot-Hawley Tariff Act, which was designed to aggressively safeguard US jobs and industry from foreign competition. Global trade retaliation quickly followed, along with a steady collapse of world trade, ultimately setting the stage for the Great Depression.

"No one, including myself, thinks such an outcome is likely," writes Roach. "Yet, that's a risk that can no longer be taken lightly, as politics comes face to face with the stresses and strains of globalization."

The prospect that G5-initiated protectionist legislation might throw a wet blanket over the entire global growth engine will inevitably force a rewrite of asset allocation models, and make identifying the next class of outperforming markets and instruments a near-impossible task.

MISSING THE TREES FOR THE FOREST

The highly charged, complicated debate about how far and how fast emerging markets will attract waves of investment capital may, in the end, prove to be a mere sideshow to the main event. Most global fund managers are benchmarked against global indices. Such global benchmarks, like the Morgan Stanley Capital International All Country Free Index, are heavily weighted toward Europe, the US, and Japan, with emerging markets representing perhaps only 4 percent.

"The debate over expected investment returns in emerging markets relative to developed markets, I think, is a false dichotomy," explains John Praveen, managing director of Global Equities and Investment Strategy at Credit Suisse Asset Management in New York, NY, USA.

If an investor heavily overweights emerging markets in a portfolio benchmarked against a global index, that will perhaps entail an 8 percent allocation rather than a 4 percent allocation. The other 92 percent will still be invested in developed markets. "The real debate instead should focus on where the bulk of investment capital will be directed," says Praveen, "for example, comparing expected returns over the next decade in the United States relative to Japan or Europe, or identifying specific sectors and issuers, such as in health care and information technology, that will outperform."

Praveen argues that it would be far more useful to identify structural trends in specific markets and how they will affect specific companies, rather than speaking to general global macroeconomic themes, which may or may not be efficiently actionable by a fund manager. With an aging population across the developed world, for instance, top-notch innovative health care and biotechnology firms are destined to see a quantum leap in their top-line revenues.

In addition, a select handful of key Indian-based biotech and pharmaceutical companies, drawing on a huge local source of talented scientists and the ability to conduct clinical trials at rock-bottom costs, may soon give the existing giants a serious run for the money and start stealing global market share. Finally, in IT, although corporate spending in this market has recently been stagnating, there is still always room for a relatively unknown small cap firm to roll out the next "killer application."

In short, while Praveen accepts that emerging markets may possibly out perform G5 markets over the next decade, it is still foolish to downplay the predominant allocation that US instruments will always represent in any manager's investment universe. "In the United States, we have seen a steady increase in productivity and R&D spending, as well as the beginnings of a recovery," he says. "Perhaps you can make a case-by-case argument for a limited allocation to certain emerging markets, but in the end, I am very confident that the US equity market will perform extremely well over the next decade."

Theodore Kim, CFA, trained as a Barrister at Law at the English Bar, has published three textbooks as well as dozens of articles on global investment, finance, and economics, and now works on Wall Street.