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The Search For New Emerging Markets

EXECUTIVE SUMMARY

BRICs growth slowing

To understand why investors are so intent on finding new emerging markets it's valuable to learn more about how the older emerging markets are fading.

China, the engine of growth in the world over the past decade, is sputtering like a worn-out Honda with a set of rusted spark plugs. State Information Center forecasters last week slashed their annualized GDP forecast to 7.5%, a figure that would be cause for celebration in the West but is low enough to induce near-panic and regime change in Beijing.

You can see the desperation virtually every day in headlines. Demand for cars in the first four months of this year was the slowest since 1998, said one report last week. Zheng Tong Auto Services and Baoxin Auto Group, which are BMW and Land Rover dealers, canceled their debut sales of dollar-denominated bonds last week, said another report, as prices of Chinese debt in the U.S. currency plunged the most since September — kicking the yield up to an unacceptable 7.6%.

This is not an academic exercise, as the sales weakness is now sloshing dangerously into corporate results. Through the second week of May, 845 companies listed on the Shanghai exchange had pre-announced first-half earnings, and half forecast earnings declines on a year-over-year basis.

These are warning signs. When China sneezes, other big emerging markets catch pneumonia. No wonder the stock exchanges in other large emerging markets, which supply the Middle Kingdom state like tributaries feed into a river, are reeling this month.

These results turn recent conventional wisdom on its head, as traditional emerging countries' domestic growth is supposed to be strong enough to let them decouple from Western stumbles.

More bluntly, investors largely shunned U.S. and European stocks in the past year and poured their money into emerging markets in the hope that countries like Brazil and India could develop strong enough consumer demand from a growing middle class that they would be able to laugh at the troubles in Paris, Athens, Berlin and Washington.

Flawed

The assumption that larger emerging markets could excel despite softness in the West was premised on the notion of faster relative growth. In other words, if GDP growth had been 12% in a strong China, a weakened growth rate of 7% was still good enough to merit special investment allocations.

The problem with that view, it turns out, according to work by Citigroup analysts, is that not nearly as much GDP growth falls to the bottom line of the more established emerging markets as in developed markets due in part to higher input prices as well as a higher level of corruption.

Another reason: The more success that companies in these countries enjoy, the more shares they sell to the public in both initial and secondary offerings — diluting earnings per share and causing valuations to swell. Also, emerging markets' consumer products companies are more "defensive," just as they are in the West, and simply don't merit valuations as high as banks and technology producers.

Moreover as pressure on the political leadership of older emerging countries intensifies with the growth squeeze, they have resorted to partly or fully nationalizing their bigger companies and managing them for the state's purposes rather than for profits. These "para-statal" companies mostly have lower returns than their fully independent counterparts.

And finally, traditional emerging markets face an ironic challenge from the decline of equity values in the West. For as the share prices of companies in developed markets sink in tandem with the worsening economy, they become cheaper faster than the emerging markets' companies. At a certain point, reached quite quickly, developed markets become more attractive. Fund managers wonder why they should take the risk of buying China and India when stocks in the Spanish, Belgian or even U.S. markets are cheaper?

The valuation differential of major emerging-market equities to developed market equities has narrowed from an average of 29% in the 2000-2009 period to an average of only 12% today, according to analysts. As the older emerging markets have matured, in other words, they are converging on developed markets' valuations.

You might think that the more mature emerging markets deserve a premium valuation to developed markets, but as mentioned a moment ago, paradoxically, there is little evidence that premium GDP growth is generating premium earnings growth.

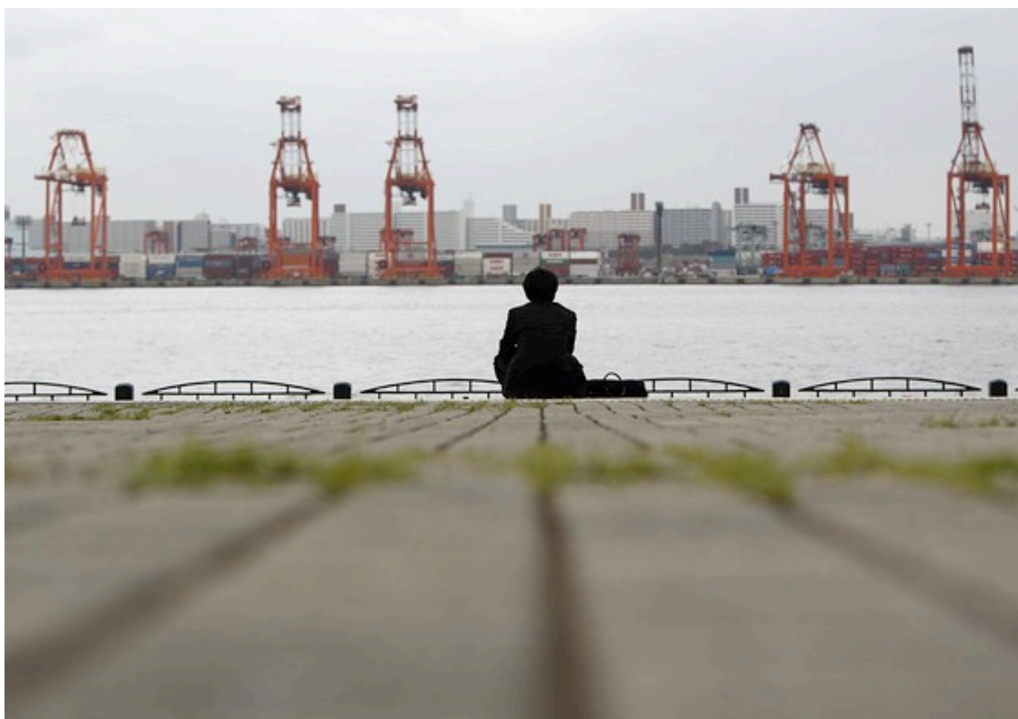
It's strange but true: The net profit margin in the older emerging markets fell from a peak of 10.4% in 2004 to 6.9% in 2011. Meanwhile the net margin in developed markets jumped from 4.6% in 2002 to 7.6% in 2004 before flattening out (erratically) through the end of last year. It's expected to rise, due to productivity improvements, to 8.6% by 2013, according to analysts.

Put another way, the net margin in the mature emerging markets in 2004 was close to 280 basis points higher than in developed markets, but by 2011 it was nearly 60 basis points lower. Overall, therefore, it would seems that premium GDP growth in emerging markets does not generate premium earnings growth mainly due to higher cost inflation and the lack of productivity.

You could conclude from this exercise that the traditional emerging markets stocks won't trade at a premium to developed market stocks until it is considered less risky to invest there. As a proxy for that, Citigroup analysts say, figure it could happen only when Brazilian debt yields trade below U.S. Treasury yields, a scenario that seems unlikely to occur for a long time.

The bottom line is that the mature emerging markets may have a lot going for them in terms of infrastructure, experience and established trading partners, but as a group their valuation advantage and premium growth halo appear to be fading.

Now it's time for the New Tigers to pick up the pace as their older brethren falter, as you will learn in the rest of this package. It's time for the global economy to race ahead by changing its stripes.



The world's 'New Tigers' lie ready to pounce

Europe : Poland and Turkey (see Report)

http://www.scribd.com/doc/112573741/121101-Europe-Poland-Turkey-The-Search-for-New-Emerging-Markets

Both countries have managed to distance themselves from Europe's continuing debt crisis.

Turkey is to Europe what Mexico has been to the U.S.

Turkey has the potential to be the economic super power of the region.

The engine of growth is the country's position as a trading hub. It stands at the crossroads of several important energy markets" as it borders Iran, Iraq and Azerbaijan, and has access to the Mediterranean Sea and the Black Sea.

International corporations increasingly prefer to use Turkey as a regional export hub because of its political stability and large domestic market.

It is the 17th most populous nation and its population is young, with only 6.3% of about 75 million people aged 65 or older, according to the U.S. Central Intelligence Agency.

It has a great location, next to affluent Europe and a booming Middle East, and with a large population and competitive wages, it's become the region's workshop.

Poland is a Proxy for Eastern Europe

Poland's economy, meanwhile, is not over-reliant on exports, is supported by a large domestic market, and was the only European economy to avoid recession in 2008-2009.

Some of the leading sectors in Poland include consumer goods, auto manufacturing and energy. Success in shale gas production is likely to be a "game-changer" for the

economy, lowering energy prices and local production costs, attracting foreign investment in local manufacturing and supporting high growth in the consumer sector.

ETFs focused on Poland include the iShares MSCI Poland Investable Market Index Fund and the Market Vectors Poland ETF , while the iShares MSCI Turkey Investable Market Index Fund provides exposure to Turkey.

Latin America : Peru and Colombia (see complete report)

http://www.scribd.com/doc/112573767/121101Latin-America-Peru-Colombia-The-Search-for-New-Emerging-Markets

Open market policies, along with political stability, young populations and competitive advantages in certain industries have helped Peru and Colombia become two of the strongest emerging economies in the region.

Peru's path to growth

Peru boasts the world's second-largest copper and silver production, and it's a major producer of gold.

Peru is an upper middle class economy with abundant supplies of copper, gold and silver and copper production will likely drive growth over the coming years.

Still, with 60% of exports in the materials sectors, Peru's market is quite cyclical and commodity prices could be very volatile.

For investors, it's important to note that many companies that trade on the U.S. stock exchange have major operations in Peru, and those include Creditcorp Ltd. and Southern Copper Corp. There's also an exchange-traded fund called the iShares MSCI All Peru Capped Index Fund.

Colombia: A reprieve from war and violence

In Colombia, household earnings are growing faster than the regional average. It has "vigorous" export growth, an uptick in oil and gas production, an impressive investment in infrastructure, disciplined economic policy-making and a stable security environment after years of violence.

Colombia is a "rarity" in Latin America. It has not only received an investment grade rating from S&P, Moody's and Fitch, but also is the only Latin American country to never default on an external debt commitment.

Colombia's mining and petroleum sectors will also outperform with half of foreign direct investment going directly into these sectors, she said.

Among the ETFs that focus on Colombia is the Global X FTSE Colombia 20 ETF .

Asia : Philippines, Indonesia and Myamar (see complete report)

http://www.scribd.com/doc/112574000/121101-Asia-Indonesia-Philippines-The-Search-for-New-Emerging-Markets

Population is an obvious strong point for Asia, and Indonesia and the Philippines have huge ones.

Large and young demographics generally help a country's growth. Those nations have close to 10% of Asia's population, or 25% excluding China and India, so consumer discretionary/staple and service industries, including financial services, are industries poised to benefit.

The Philippines has a bit of an advantage in the region

It's had a "tremendous investment and collaboration with U.S. interests since its independence. Its involvement has kept its economy going despite ineffectual and corrupt governments over the years.

There has also been quite a bit of progress in terms of the war on corruption, in infrastructure, and fiscal consolidation — all of which should boost the country's growth potential in the coming years.

And among the sectors with significant potential is information technology and business process outsourcing.

The Philippines has overtaken India as the world's largest provider of call-center services by revenue, buoyed by the rapid rise of the country's IT-BPO industry," which expanded last year at a rate of 24% year on year with the country's success largely attributed to its English language standard.

Indonesia : Consumption has key to growth

Domestic consumption has seen rapid growth in the last few years, driven by the rising income of the average Indonesian and its economy is much less dependent on external factors than other South East Asian countries.

Investors wanting to gain exposure to Asia can look to multinational companies that are setting up or have set up a presence in the area. Some of those include DuPont (NYSE:DD) , Dow Chemical Co. (NYSE:DOW) and Veolia Environment (NYSE:VE) .

These companies can offer investors a way to reap some of the rewards while at the same time having diversification from a geographical and sector perspective.

Among the mutual funds that focus on the Philippines are balanced funds such as the ALFM Growth Fund and stock funds such as the Philam Strategic Growth Fund. For Indonesia, there's the Market Vectors Indonesia Index ETF.

Myanmar : Oil, Gas… And The Riches That Follow!

The international community, the human rights defenders and ardent supporters of Aung San Suu Kyi are delighted at it: for approximately one year Myanmar opens to the international community. The political softening which led to the normalization of the political presence of the " Lady of Rangoon ", was a prelude to the second phase which began a few months ago: the economic opening and the liberalization of the economy.

The error not to commit is to believe that this political and economic opening is imposed upon the junta. It is on the contrary totally controlled by the military elites. First phase, always underway in the country: create a climate favoring the business and to the legal safety. Since last spring, a team of the World Bank has settled down in the country to train the local administration. In April, a reform allowed to stabilize the exchange rate of the kyat, the national currency.

But the standardization of the standards in Myanmar risks to be long and complex, in cause: the resistances of the most conservative fringes of the junta.

Sectors of future and perspectives? Sector attracting most the greed of the western companies, the hydrocarbons. Myanmar is indeed one of Asian countries in the most important potential, with at least 2 540 billions of m3 of reserves estimated in natural gas, of which at least already exploitable 510 billions.

Other sectors promising beautiful perspectives: the heavy industry, the mass-market retailing, the textile industry (which tariff barriers sanctioning the country get up little by little) or the perfume industry.

But in Myanmar which opens hardly in the international investments, the ground swell which seems to engage is sure to last? Can the country represent a stable prospect (perspective) for the investors?

Africa : Ghana

Opportunities in Africa aren't quite as transparent and there are more risks involved with that region.

Most African nations that do have stock exchanges have ones that are not large or liquid enough — or easy enough to trade in for the majority of investors.But there is "tremendous opportunity" in the natural resource sector, local tourism and construction, he said.

Ghana's rapidly expanding economy is fueled by increasing revenue from high commodity prices for cocoa, gold and … oil. With oil production expected to increase every year through at least 2015 at the Jubilee oil field, the nation's government will have the revenue to continue infrastructure upgrades that raise Ghanaians' standard of living and attract foreign investment.

Earlier in May, a senior energy official told Reuters that the government plans to raise its oil revenues to $650 million in 2012, from $350 million last year.

It has yet to be seen if oil-related revenue is spent wisely. Another issue is that its population is small, so it's tough for Ghana's economy to have a broad impact on the region.

Analysts also see potential and risks in Uganda.

Development of Uganda's oil infrastructure is expected to attract more than $10 billion in the next two years — a scenario that promises to accelerate Uganda's overall growth prospects as well as its fiscal position.

At the same time, the country's main driver of foreign direct investment is increased trade coming from regional integration within the East African community, she said. The knock-on effect of increased trade is infrastructure projects in road, rail and port development that will benefit the region and investors in the long term.

That development in transportation and infrastructure will help offset disadvantages involved with being a landlocked country, though being landlocked also means that it shares borders with five other African countries.

Other nations in Africa represent good opportunities and another aspect to look at would be political stability.

In the analysis of growth potential, political leadership is a factor that has been overlooked. Both Senegal and Malawi have experienced recent ‘peaceful’ changes in government to leaders who are truly part of the new generation of leadership and thus may experience additional growth.

In terms of investing, there’s the Nile Pan Africa Fund , a “‘pure play’ fund that exclusively focuses on investing on the Africa continent.