

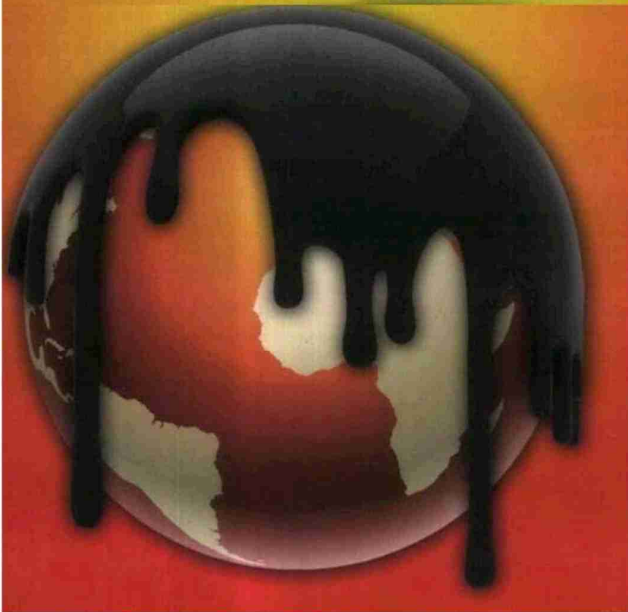
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# SLICK TRADES

Last week crude oil hit a two-and-a-half year high just short of \$120 a barrel and put further pressure on emerging economies, which were already struggling to digest the impact of rising food prices. Russ Mould investigates the implications for emerging markets and highlights four tactical trades and six long-term buys to help investors benefit from rising oil and commodity prices amid ongoing geopolitical uncertainty.



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merging markets (EMs) and frontier markets (FMs) have wobbled as the follow-on repercussions of commodity-price inflation have begun to sink in. The threat to growth posed by booming raw material prices has become all the more acute following oil's romp to two-and-a-half-year highs. Rising interest rates, an associated slowdown in economic growth, and growing political turmoil are all potential conse-

quences of a commodity-driven inflationary spike, itself the result of extremely loose monetary policy in the developed nations, and particularly the USA.

Since it is the prospect of strong economic growth which attracts investors to EMs and FMs in the first place, events which threaten this outlook will naturally hit sentiment particularly hard. This can be seen in the indiscriminate sell-off of EM and FM arenas since the start of 2011 and a steady flow of cash back to developed markets (DMs) in the West. Yet *Shares* would argue the picture is much more nuanced, not least because there are a handful of EMs and FMs that are self-sufficient in key commodities including oil. These nations, and also those who are so resource-rich they are even net exporters, should be beneficiaries of booming oil and crop prices.

We have therefore formulated ten key EM and FM trades. Four of them are designed to deal with the short term for aggressive traders who are seeking to capitalise upon the volatility across asset classes that is resulting from the ongoing crisis in Libya and indeed across the Middle East and North Africa (MENA) region. They favour commodity-laden countries.

For the longer term, any pullbacks in certain key EM and FM indices can be seen as a buying opportunity. Commodity prices will slide back eventually, not least because the ulti-



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mate cure for high raw material prices is high raw material prices. Demand destruction will inevitably follow as consumers and corporates either cut back on spending as best they can or seek out alternatives. The commodity price plunges of 2008 are a perfect example of this. We have therefore identified six long-term buys markets. They will be beneficiaries as easing oil and crop prices and a return of both market risk appetite should see their superior growth trajectories come back in to favour with investors.

Based on the belief that oil and food prices are going to remain elevated in the short-term, our four short-term tactical trades are centred around EM nations which are self-sufficient in, and export, key commodities. To our minds this dictates four long positions: Brazil, Russia, Mongolia and Qatar. Our preferred plays on these markets are the **iShares MSCI Brazil (IBZL)** exchange-traded fund (ETF), **Lukoil (LKOD)**, private equity group **Origo Partners (OPP:AIM)** and the **Epicure Qatar Equity Opportunities Fund (EQEO:AIM)** respectively (see page 18).

Over the long term, food and oil prices will likely revert to more normal levels so investors should take advantage of the EM/FM pullback and gain exposure to China, Indonesia, South Korea and Vietnam. Falling commodity prices would reduce inflationary pressures, in turn interest rates, soothe any external balance of payments problems and dampen political unrest. Once confidence returns and economic fundamentals reassert themselves, patient investors should be rewarded. **Hutchison China Meditech (HCM:AIM)** is a good way to get Chinese exposure; **db x-trackers MSCI Indonesia TRN Index (XMID)** a solid route in to Indonesia while **Samsung Electronics (005930:KS)**, which also has London and New York listings, a way to play South Korea. Use **Vietnam Holding (VNH:AIM)** to access this FM market, being our fourth long-term trade and current *Play of the Week* (see *Plays, Shares*, 17 Feb).

Our two remaining exposures to long-term trades – being India and Poland – take inspiration from the belief that early EM rate movers will come out the current commodity-driven inflationary environment all the stronger and with



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credibility reinforced. Indian and Polish central bankers have made early interest rate moves and our preferred route in to India is **Lxyor ETF S&P CNX Nifty India (LNFT)** while for Polish exposure we like **DP Poland (DPP:AIM)**. All six of our long-term trades are set out in detail on pages 20-21.

### Brave new world

Even though Western commentators have embraced regime change in Tunisia and the possibility of democracy in Egypt, the latter's stock market was still shut down for days. This will have only served to reaffirm the prejudices of those who share the views of Henry Grunfeld, co-founder of the British investment bank SG Warburg, which is now part of UBS. He would habitually advise colleagues that emerging markets were 'emergency' markets from which it was impossible to emerge when all went wrong – as it inevitably would at some stage, in his view.



As unrest has spread from Libya in the east to Yemen in the west of the Middle East and North Africa (MENA) region investors have taken fright, Grunfeld would not have been surprised by the \$10 billion withdrawal of cash from EM and FM funds over a two-week period in February. That money found a home in the supposedly safer DM arenas of America and Europe, which have started to outperform their emerging counterparts for the first time since 2008.

### Five bear points

Following Tunisia's Jasmine Revolution, Hosni Mubarak's fall from power in Egypt and the bloodshed in Libya, there are good reasons to approach EMs and FMs with greater caution, at least in the short term and they are not just geopolitical.

- **Inflation:** Inflation in Vietnam reached 12% in January, Indian food price hikes have scaled 17% and the rise in the cost of living hit 6% in Brazil the very same month. Asian util-

ities have found themselves faced with a 36% hike in the cost of coal following floods and production losses in Australia, Indonesia, South Africa and Colombia.





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• **Rising interest rates:** Rising prices mean many EM central banks will need to hike the cost of borrowing and fast to head off any inflationary spiral, which would threaten growth, currency stability and even some political regimes. Chile, Israel, South Korea, Indonesia, China, Hungary, India, Poland and Brazil have already acted. Further moves are likely, especially in China, India and Brazil where the authorities are seeking to cool their economies down. Ironically this may mean expansion here – and thus corporate earnings – starts to slow just as the West begins

to gain traction, helped by record low interest rates and fiscal laxity in the form of quantitative easing (QE) money-printing programmes. Short term, this may make DMs look more attractive than EMs on an earnings forecast momentum basis. →

• **Political unrest:** This also relates to rising food prices. This issue was at least a partial catalyst for the uprising in Egypt and has put many other nations on red alert. Last month (16 Feb) the city of Shanghai announced a 10% hike in the minimum wage to head off any repeat of the unrest seen in 2010, in response to increases in the cost of living. Meanwhile Morocco has almost doubled the amount of additional cash it has set aside to fund food and oil purchases from 17 billion dirhams (\$2.0 billion) to 32 billion (\$3.8 billion). Countries who import important foodstuffs and fuel are scrambling to build up stockpiles, exporters are hoarding. A World Bank report (16 Feb) claimed 44 million people had been pushed into what it calls extreme poverty – those who live on less than \$1.25 a day – and cited a 15% hike in its food price index as the reason. That benchmark has got to within 3% of its 2008 peak when food prices sparked riots across Asia and Africa. Any government, despotic or otherwise, will be seeking to ensure adequate supplies for its people, and hence our short-term tactical caution on EMs relative to DMs. The commodity spike in 2008 did a lot of damage to EM markets, when even Brazil, India and China all halved, although the global credit crisis hardly helped here, either. Nor do political problems only come in the form of revolutions over food prices. Argentina is resource rich but a succession of comical presidencies and economic policies leaves it with almost pariah status, although its reputation is nowhere near as bad as that of Venezuela under maverick communist president Hugo Chavez, even though that country is one of the world's top ten crude oil producers.



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• **Fears of an asset bubble:** Many central bankers and politicians alike across the world's fledgling economic powers will no doubt be cursing US Federal Reserve chairman Ben Bernanke. His move to slash US interest rates to an all-time low of zero to 0.25% and electronically create \$2.35 trillion out of thin air via two QE programmes has caused a wave of cash to slosh around the world, looking for a home in the form of premium investment returns. Some of this has moved in to commodities, some into risk assets such as equities, especially in emerging markets. These money flows have driven up emerging currencies, forced local central banks to keep their own interest rates artificially low to prevent additional currency appreciation, driving equity valuations higher still as more money has flooded from cash and bonds in to shares. This scenario means, some commentators argue, QE has created a bubble in risk assets such as EM and FM equities which will burst as soon as stimulus is withdrawn. America's \$600 billion second round of Quantitative Easing (QE-II), is due to end in June of this year.

• **The consensus is still positive:** A very useful survey from Barclays Stockbrokers published in February may have been of some concern to EM and FM bulls and interest to contrarian bears. The report showed 52% of the 863 respondents thought emerging markets would offer the best returns in 2011, against 24% for the UK, 18% for the US and just 6% for Europe. That could be interpreted to mean the EMs are now the consensus play and as such much of the good news is priced in. It may take little to shake up the rosy scenario, especially after a prolonged period of outperformance.

To *Shares'* eyes concerns about EMs and FM's are legitimate – especially those on the issues of food and energy inflation and the

possibly overly bullish consensus. It is these worries which lead us to believe short-term EM and FM performance will see much greater divergence this year and a more careful market selection is required. As a reflection of this our four preferred short-term plays for the next three to nine months are Brazil, Mongolia, Qatar and Russia.



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#### Five bull points

Most of the above concerns relate to the short term and, as argued, may well dissipate as soon as food prices ease. The long-term case for emerging markets still stands, even if it is relatively well understood, and the key plank of that is economic growth.

- **Premium economic growth:** Any arguments that EM and FM nations could entirely decouple from the West were shot down in flames during the credit crisis of 2008 to 2009 but there was no denying the emerging powers still did so much better. The chart above from the International Monetary Fund's latest *World Economic Outlook* report (25 Jan) shows emerging and developing economies suffered economic decline for just six months – the final quarter of 2008 and first one of 2009 – against four in the advanced nations. The shrinkage was also much less severe. More importantly this outperformance is expected to continue with trend growth in the West and Japan expected to run between 2% and 3% per annum in 2011 and 2012 against 6% to 7% across emerging nations. Even if Brazil, India and China all show deceleration in 2011 their short and long-term prospects still easily outstrip those of the West.

- **Low budget deficits:** Many EM nations, particularly Asian ones, have strong balance sheets and low budget deficits, not least as the harsh lessons of the 1997-98 crisis, when excess foreign debts caused horrendous currency devaluations, have been learned.

- **Currency appreciation:** The Indonesian rupiah, South Korean won, Thai baht, and Malaysian ringgit were all slaughtered in 1997-98 as excess debts proved too heavy a burden and devaluation the only way out, alongside fierce International Monetary Fund austerity programmes. Yet the picture now is so very much different. At the time of writing the Korean won stands at KRW 1,101.9 to the dollar, its highest level



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since September 2008 while the Taiwanese dollar has surged to a 13-year high against the greenback at NT\$28.8970. Brazil, South Korea and China are trying to stop their currencies

rising further against their Western counterparts but this may not be easy as their long-term fundamentals remain so much the stronger. Any gains in these local currencies will add to investment performers for overseas investors, once their holdings are valued, or sold and repatriated back in to their own currencies.

• **Commodity exposure:** While some nations are seeing economic growth reined in, corporate margins squeezed and politicians put under pressure, many others are resource rich and should be net beneficiaries from soaring commodity prices. Over 70% of Uruguayan GDP is related to agriculture, while Brazil is one of the world's leading players in iron ore, oil and sugar. Oil-rich Russia, the Middle East and Colombia are all potential winners, while soaring industrial metals prices should boost Chile to name but one.

• **Short-term panic:** In just a few weeks in February alone, over \$10 billion in funds fled EM and FM funds and returned from these nascent arenas to the supposed relative safety of the DMs in America and also Europe. To many this will seem particularly ironic given the ongoing debt crisis in the latter and the former's struggles to reduce its budget deficit while stimulating employment growth. Contrarian investors might therefore decide the panic is overdone as the long-term economic fundamentals remain sound and EM and FM indices and stocks alike will rebound once food prices finally retreat to

less elevated levels. In addition, as *Shares* has indicated previously (see *Opinion, Shares*, 3 Feb) prior political and economic crises in the emerging markets rapidly blew over. The Iranian coup of 1979 and failed bid to oust then president Gorbachev in Russia in 1991 hit worldwide sentiment only for markets to rapidly bounce back, while the Mexican and Asian currency crises of 1994-95 and 1997-98 ultimately failed to deflect the FTSE All-Share from its long-term upward trajectory for long (see charts on page 19).

As the above five factors make their presence felt, EMs





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and FMs should offer patient investors premium portfolio returns. The key to this is faster economic growth than that likely to be on offer in the West or Japan. Our six preferred plays for the next two to five years are China, India, Indonesia, Poland, South Korea and Vietnam.

**Five key issues, ten key trades**

In sum, five key issues will determine the performance of EMs and FMs in absolute terms and relative to DMs: food inflation, energy prices, interest rate trends, political developments and

above all economic growth. They are all interlinked and will require careful attention. It is the premium economic returns which over time should make developing market exposure particularly worthwhile even if there will be lumps and bumps along the way. This can be attained via stocks listed on the **London Stock Exchange (LSE)** that have operations or sales in those countries; via direct investment on those nations' bourses; via collectives such as funds; and increasingly via tracking products such as ETFs. Our ten plays – four tactical for short term and six strategic for long – use this full spectrum of instruments. ■



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## KNOW YOUR MARKETS

### Developed markets

Developed markets (DMs) cover high-income economies with highly liquid, easily traded and well regulated capital markets. Low transaction costs, free movement of capital, a developed derivatives market and high standards of corporate governance with careful protection of shareholders' rights all typify a DM arena, where market capitalisations often represent a big percentage of national GDP and the number of firms listed runs in to the thousands. According to FTSE as of last autumn, 26 nations qualified as DMs, including the UK, USA, Canada, all of Western Europe, Japan, Hong Kong and Australia.

### Emerging markets

Emerging markets (EMs) are those witnessing high levels of economic growth, rapid levels of industrialisation and vibrant development of bond, currency and equity markets. FTSE classifications categorise EM nations as either advanced or secondary. Advanced EM nations are those seen as having upper-middle incomes with highly developed stock exchanges or those with high incomes and less advanced capital markets. At the last count, there were six advanced EMs – Brazil, Hungary, Mexico, Poland, South African and Taiwan. Secondary EM names have less developed financial markets or lower incomes. They include India, China and Russia, as well as Colombia, the Czech Republic, Indonesia, Thailand and Turkey.

### Frontier markets

Frontier markets (FMs) have lower market capitalisations and less developed economies than the more developed and better-known emerging markets (EMs). Investment restrictions may also serve to restrict liquidity and FMs are generally higher-risk arenas and are suitable only for those investors with a high tolerance for risk and long-term time horizons. The hope is over time their economies, markets and corporate governance standards develop sufficiently to attract further capital, improve liquidity and provide the consistency of returns associated with the longer-established EM stock exchanges. A September 2010 FTSE classification of FMs covered 25 different countries ranging from Croatia and Serbia in Europe, to Qatar and Bahrain in the Middle East, Botswana in Africa, Vietnam and Bangladesh in Asia and Argentina in Latin America. The exchange-traded fund **db x-trackers S&P Select Frontier (XSFR)** was issued in 2007 by db x-trackers, alongside its dollar-denominated cousin which trades under the Epic code of XSFD.

A full explanation of how FTSE classifies countries can be found at

[http://www.ftse.com/Indices/Country\\_Classification/Downloads/Sept%202010/FTSE\\_Country\\_Classification\\_Sept\\_2010\\_Update.pdf](http://www.ftse.com/Indices/Country_Classification/Downloads/Sept%202010/FTSE_Country_Classification_Sept_2010_Update.pdf).



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### MONGOLIA


**Origo Partners**  
(OPP:AIM) 48.5p **+ BUY**

Mongolia's vast riches of untapped natural resources are becoming big news and as an investor in Mongolia-based assets private equity group Origo Partners (OPP:AIM) offers London-based investors an interesting entry point. The Mongolian government has begun construction on the world's largest undeveloped copper-gold deposit, Oyu Tolgoi, in partnership with Rio Tinto (RIO) and Ivanhoe Mines (IVN:TSX) and the nation is also blessed with ample coal reserves. Chinese investment in rail links and higher commodity prices are a key driver for the economy. Origo has investments in four miners active in Mongolia in addition to stakes in firms active across in Asia in water desalination and agriculture. February's \$60 million placing should give further firepower for acquisitions in both China and Mongolia.



**ORIGO PARTNERS**  
**FTSE ALL WORLD**  
Rebased to first

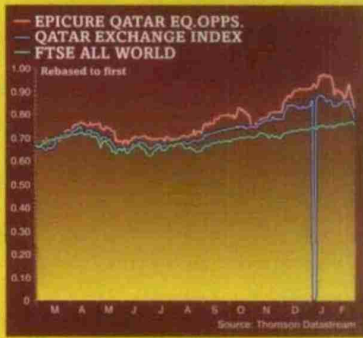
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### QATAR

**Epicure Qatar Equity Opportunities Fund**  
(EQEO:AIM) \$0.86 **+ BUY**

As a result of its oil and gas riches, Qatar consistently posts budget surpluses and its economy is growing like fury – it has the third largest estimated gas reserves in the world and resources account for 50% of GDP. The emirate is estimated to have the second highest GDP per capita figure in the world and the government – an absolute monarchy established in 1985 -- looks to be one of the soundest in the region. All of these factors should mean Qatar is a relatively safe short-term play and in the long term the 2022 World Cup and the possibility it could be upgraded from FM status to a full emerging market – and therefore worthy of inclusion in the MSCI Emerging Markets index – also bode well. These themes can be safely and effectively played via the Epicure Qatar Equity Opportunities Fund (EQEO:AIM), which trades at a 17% discount to its net asset value and even offers a 3% yield. Late last month (21 Feb) the firm announced plans to move to the Main Market, change its name to Qatar Investment Fund and change its fee structure.



**EPICURE QATAR EQ.OPPS.**  
**QATAR EXCHANGE INDEX**  
**FTSE ALL WORLD**  
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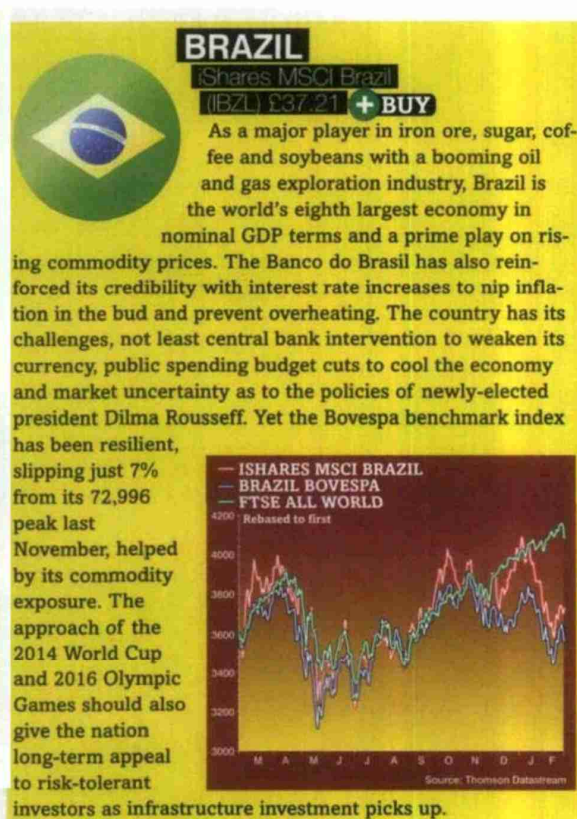
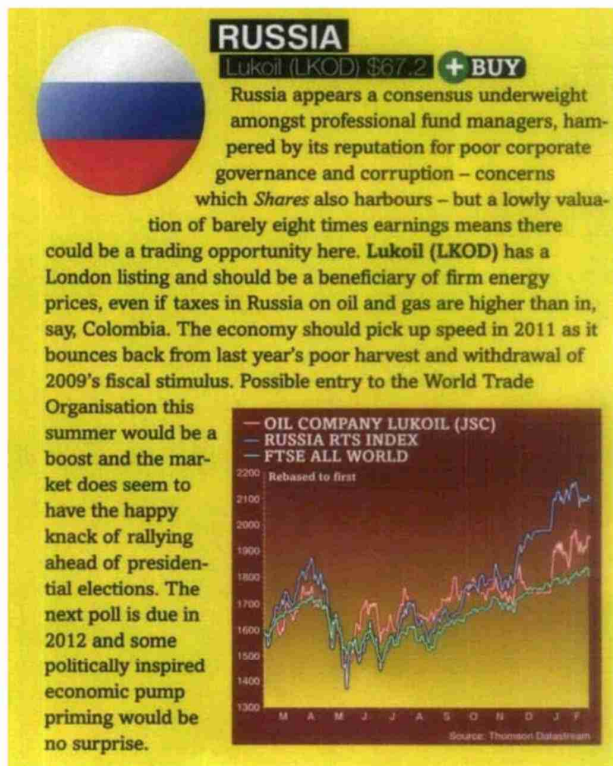
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**David Gait,**  
 manager, First State Indian  
 Subcontinent

While a long-term believer in India's growth story, David Gait accepts there are some short-term issues that need to be borne in mind. 'Inflation is one of the most pressing issues facing the Indian government in 2011, with further attempts to rein in expectations likely. Valuations have also reached full territory, reinforcing our capital preservation instincts.' When added to a string of corruption scandals highlighting lingering corporate governance issues, this means he is continuing to focus on companies with strong 'price-giving' franchises, robust management and sustainable cashflows. His top holding is **Idea Cellular (IDEA:BSE)**. (CM)



**Kevin Scutt,**  
 manager, Premier  
 Environmental Power  
 and Water

Scutt's largest holding is **China Water Affairs (G0855:HK)** which is involved in water treatment as well as supply and hydro-electric power. He says China's government is putting a lot of emphasis on waste water in particular: 'All the big and second-tier cities have waste water treatment but at the smaller end it is put straight in to the rivers.' He says the latest five-year investment plan to address waste water issues is double the budget allocated under the previous plan. He is also keen on the water sector in India and peripheral Asian emerging markets such as Thailand. (SK)



**Rami Sidani,**  
 co-manager, Schroder  
 Middle East

Sidani believes the political unrest in Tunisia and Egypt does mean risk of contagion exists but argues the longer-term impact on the rest of the markets will be limited. He comments: 'The direct impact of recent events is likely to be limited to Egypt, but the indirect effect of regional uncertainty is expected to be negative for risk assets in general until we have more clarity on the outcome of events in Egypt.' He is keenest on Qatar as 'it offers strong earnings growth and attractive stock picking opportunities.' A top holding in the fund is **National Bank of Kuwait (NBK:KK)**. (CM)



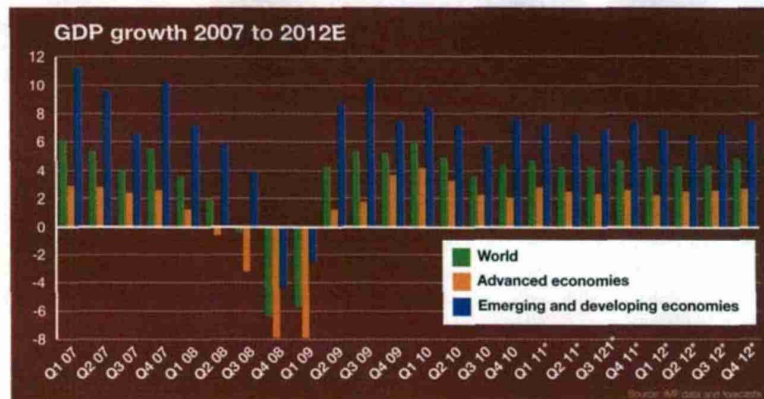
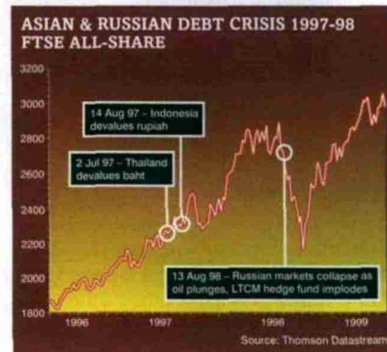
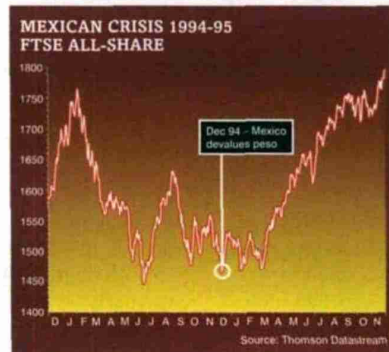
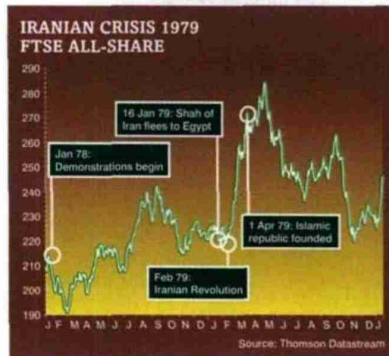
**Sebastian Luparia,**  
 manager, JPMorgan Brazil  
 Investment Trust

Luparia is angling the investment trust towards domestic plays. He says that with inflation in Brazil now running at historically low levels consumers' real incomes are increasing and he is playing his domestic theme through plays such as **OdontoPrev (ODPV3:BR)**, a provider of pre-paid dental plans. He says: 'This year inflation will be 6%, inflation was in the high 20s if you go back ten years ago.' Construction is another theme, through holdings such as **Mills (MILS3:BR)**, a provider of equipment to the building trade, as he sees the government focusing on bottlenecks in the transport system. (SK)



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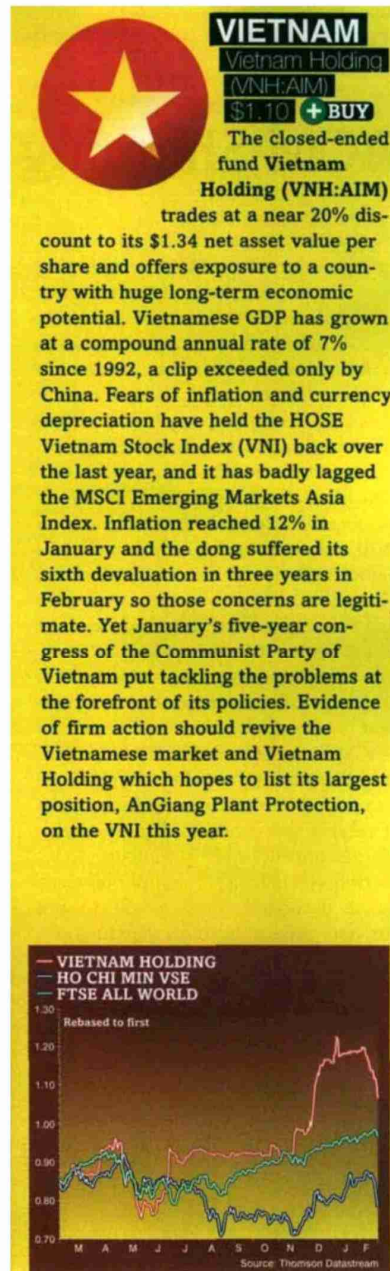
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