The Spectrum IFA Group

Independent Financial Advisers

HSBC Global Asset Management

Emerging Markets Conference: The Changing Nature of Emerging Markets

Tuesday 6 May, 2008
Park Hyatt Hotel, Zurich

Overview. We were honoured to be invited to this incredible conference by John Croft of HSBC Global Asset management and fortunately two of our advisers could attend. Peter Brooke (based in the South of France) and Chris Eaborn (based in the Geneva area) have produced two reports on this prestigious event.

Much of the conference was a discussion of the ECONOMICS of global and emerging markets and thus what we can draw from it for our retail market and clients is based on the belief that these changes in the economic situation have a direct link to stock market performance. It is generally accepted that economics plays a very important part in the long term prospects for equity returns but has less of an impact on short term trends, this report should be read with this in mind. We have decided to break it up as follows:

Speaker contents and graphs – this is a more detailed look at what each speaker presented or discussed as part of the panel.

Nuggets and gems – these will hopefully be useful sound bites or quotes to give a view of the current outlook for both emerging and developed markets.

Welcome by Christian Deseglise, Global Head of Emerging Markets, HSBC Global Asset Management & Stuart Gulliver, Executive Director, HSBC Holdings plc.

Speaker contents
Some of the Spectrum IFA Group has seen Christian talk before; 2 years ago he presented the story for BRIC to our senior advisers at our European Conference. He is an accomplished speaker and expert on these markets.

Christian & Stuart focused on three main questions for the panels which were revisited over the day:

1. CREDIT CRISIS
Will globalisation help solve this as the problem or has it become much more complicated?
Could we look back on the period from 1998 – 2007 as the purple patch for the banking sector and could the sector be set for a return to its roots?
Will this crisis speed up the inevitable shift of global economic power to the east?

2. FOOD PRICE INFLATION
As wealth spreads and diets change how is the world going to keep up with the demand for this change?

3. DECOUPLING - Can the emerging markets (especially the bigger players) 'decouple' from the developed world? Consider the following key drivers:

a. Global Banking
b. Consumer spending in the USA
c. US/Global corporations taking large local stakes in the emerging markets.

Stuart suggested that instead of total decoupling he believes that too many strong links are in place and so why would decoupling happen now?

Nuggets and gems -

- The emerging markets are now NET CREDITORS to the world economy
- "There is a dizzying change occurring"
- "These markets have large, young and skilled demographics which are turning the world on its head."
- Was considered as a risky investment class, now it is truly an opportunity!
- Could it be that it will be the Emerging markets that primarily fund the emerging economies?
- 1kg of meat requires 6kg of wheat!!!

Session 1: Market Disruptions and Policy Challenges Chaired by Pam Woodall, Asia Economics Editor, the Economist

Speaker contents

This session concentrated on a lot of the economic indicators for growth and how the central banks of these countries can manage their accounts and which strategy may be best for them in the future.

• David Hale, Chairman, Hale Global Advisers

Mr Hale more or less 'blamed' the emerging markets for a large part of the current global 'crisis'. Many of these developing countries are running huge current account surpluses and this excess of cash in the world has pushed down bond yields. When this happens we tend to have strong property price growth, which led to 'reckless' property and debt selling in the US… which led to the credit crunch now. The irony is that it is the emerging markets **sovereign funds** that are now bailing out the developed countries banking systems. He didn't imply that any of this was pre-meditated but his point proves what a different world we are now living in and that we didn't really see it coming.

In the US most of this problem has come from the housing market, which is already down 15-20% in some parts and will leave some 15million households in negative equity by the end of 2008. The causes of this problem have mainly been linked to two issues:

1. Unscrupulous mortgage salesmen, little or no regulation for debt sales.
2. No penalty for default in US law. Simply hand over the keys and walk away, this could write down $500million of US banking capital in one go.

So monetary policy changes are required to combat this and to help the US recover.

1. cut interest rates
2. bail out the financial system
3. programme of tax cuts and mortgage underwriting
4. regulatory changes to the financial services industry

The cost of all of this is high inflation and a falling dollar.

• Jacob Frenkel, Vice-Chairman, AIG Inc and Chairman, Group of Thirty (G30)
Mr Frenkel's observations were very similar to those of Mr Hale, the risks to the global economy start in the US though both discussed the idea that due to the 'decoupling' of the emerging economies from the US then any recession in the US is unlikely to have an enormous affect on their growth outlooks and therefore that of the world.

The thing to keep an eye of the next 2 quarters will remain the US housing market and US Consumer. If both of these fail then a recession is very likely. If US corporate profits can be maintained then unemployment shouldn't increase too much and the US consumer will still have some cash in their pocket to spend.

If the US does enter recession then Canada and some of Latin America will feel the pinch too as they a more reliant on the US consumer. Only 20% of Chinese exports end up in the US.

• Stephen King, Group Chief Economist, HSBC Bank plc
Mr King followed the other two speakers but now swung our concentration more away from the US and onto the emerging and developing economies. The emerging markets are now contributing more then ever in history. They are now the KEY contributors in trade with the US/Europe and Japan and not just amongst themselves.
What has caused this revolution?

1. The collapsing cost of communication – this is all forms of travel and shipping as well as the massive shift to a technology driven world.
2. The changing political landscape. In terms of international trade agreements, monetary policy, the spread of the communication with new markets (e.g. the opening of Europe after the Berlin wall came down).

Policy Panel
The panel then discussed what has been presented and are challenged by the chairperson to elaborate on various issues.
• Cheng Siwei, Dean of Management School of Graduate University of Chinese Academy of Sciences, People's Republic of China
• Guillermo Ortiz, Governor, Central Bank of Mexico
• Martín Redrado, Governor, Central Bank of Argentina

CAN EMERGING MARKETS DECOUPLE?
The key message from these discussions was not about total decoupling but the need for the emerging markets to diversify their trade with many countries. This is especially true for **Latin America** who is heavily dependent on trade with the US. The Latin American central banks have learned the hard way from previous financial crises and concentrate hard on not falling into these crises again.

They now show much greater fiscal discipline, have exchange rate flexibility and monetary procedure and they understand their neighbours own cultures and politics better than ever before. Argentina especially is keen to grow their domestic financial markets and now produce "food" and not just the raw materials to make the food.
What they admitted to missing, however, is labour efficiency and a strong competitive structure to help grow their economies even faster.

From the Asian perspective they prefer the term **'partial decoupling'**
The link with the US is not so important, especially to CHINA, so a total decoupling is not necessary for the protection of the growth in the economy. They are concerned by the price of oil as more people buy cars in Asia and if the price continues to increase this will have an impact on the growth of these developing economies.

The emerging markets *are* concerned by **inflation** and monetary policy will have to change to protect from this continued inflationary pressure. It is this policy which will take time and effort to get right and each of these economies will need to find their own route to a solution (especially with respect to their exchange rate policy).
The historical danger to emerging economies is 'overspending and indebtedness'. If the EM appear to be more attractive to invest in then capital flows in and this leads to overspending, the boom can then lead to the over confident use of debt. There must be strict capital controls in place to help sterilise these inflows. These capital controls must include transparency and disclosure – this therefore means a change in many regulatory or supervisory cultures.

Nuggets and gems -

- For the foreseeable future the world's new growth engine will be the developing world, not the demographically challenged OECD countries.
- The US is less important to world growth than ever before.
- 120 countries achieved growth rates above 4% during 2007.
- Inflation is more of a risk to emerging markets than a slowdown in the US economy.
- Bubbles are inherent to markets and corrections are normal.
- "RISK has been miss-priced for way too long, when interest rates are too low for too long then investors look for higher yield without fully understanding that they must accept higher risk."
- The emerging markets economies cannot really be bundled together in one box, all of them are very different!! Maybe we should consider them as TRANSITIONARY ECONOMIES?

Session 2: Financial and Corporate Globalisation: The World Economy Through the Mirror of the Emerging Economies - Chaired by Martin Wolf, Chief Economics Commentator, Financial Times

• Mansoor Dailami, Manager, International Finance, World Bank

• John Ramsay, Group Chief Financial Officer, Syngenta

• Cheng Siwei, Dean of Management School of Graduate University of Chinese Academy of Sciences, People's Republic of China

• Robert Mundell, Nobel Economics Prize, Professor of Economics, Columbia University

Speaker contents
The speakers broke 'globalisation' down to 3 main parts:
1. MACRO –
The US housing recession could last all of the rest of 2008.
The Euro creates potential for a bipolar currency world. There is, for the first time, a real alternative to the USD.
The natural long term inflation linked price for oil would be $100per barrel today, so it is only at a slight premium now.
The price of gold is currently only 10 x that of oil, in 1980s flight from USD gold was trading at 25x the price of oil.

2. Corporate globalisation –
Many new EM companies are now globally recognised and traded companies.
There has been a 6 fold increase in the capital raised by these companies since 2002, and most are now considered blue chip businesses.

3. Food Globalisation

For 7 out of the last 8 years demand has outstripped supply of food. This is mainly down to the urbanisation and growth of EM populations who now demand a higher quality and more protein rich diet. Each hectare of farming land now has to feed 5 people compared with 2 in 1965.
Only 5% of world grain production is affected by bio-fuels, and rice is completely unaffected. The bio-fuels argument is therefore marginal.
The EM countries have enough potential to feed themselves and the rest of the world. (70% of the world's wheat is produced by EM countries)
The solution for this food crisis is for governments to get involved with improving infrastructure and irrigation and farmers need to remain incentivised by their governments or by being exposed to a free open market.

Globalisation perspective – CHINA

China has a slight problem with excess liquidity at the moment and must find a balance between spending and saving to avoid overheating. They are worried that the country just looks like a good speculative bet from overseas investors; this brings more money into the economy and leads to greater excess surplus.
China is a midway industrialised country and has a duel economic structure – URBAN/RURAL which has its roots in a COLONIAL/FEUDAL past.
The Chinese people must begin to spend more as the saving rate is currently over 50% of GDP per capita, though strict controls need to be put in place so that the economy does not overheat and follow the European/US route of boom and bust.

Nuggets and gems

- There will be 3 quarters of stagnation in US economy then a steady recover with the US dollar recovering well in the start of 2009!
- In 1978 China accounted for 1% of global GDP, in 2007 it was 5%.

Session 3: The Changing Nature of the Emerging Market Asset Class – Investment Implications
Chaired by Peter Marber, Global Head of GEM Fixed Income and Currencies, Halbis

Speaker contents

All of the above was leading the way to the final part, how does this decoupling potential, food price inflation, monetary policy change, economic growth convert to investment performance across the range of EM asset classes and is it still a good bet?

• Chukwuma Soludo, Governor, Central Bank of Nigeria

• Bandid Nijathaworn, Deputy Governor, Financial Institutions Stability, Bank of Thailand

• Philip Turner, Head of Secretariat Group, Bank for International Settlements

• Cynthia Steer, Managing Director, Chief Research Strategist, RogersCasey

• Philip Poole, Global Head of Emerging Market Research and Chief Emerging Market Economist, HSBC Bank plc

Many of the EM countries have survived and learnt from various local and regional crises. This has lead to reforms in the monetary and fiscal policies of these countries which are now the key drivers behind the change in the EM economies. This has allowed companies a strong financial and regulatory environment for them to launch and succeed, both domestically and globally. The working populations in these countries really now BELIEVE in their countries and economies for the long term and the Ems have managed to set trade with other EMs as well as with the developed world.

The huge companies from some of the EMs are tomorrows multinationals though there are still enormous variances in these economies.

Nuggets and Gems

HSBC current asset allocation and outlook in emerging markets:

Overweight equities, overweight Middle East, bullish China and Russia, neutral Latin America,
Underweight RSA, Hungary, Turkey, India and Philippines.
+ ve on commodities and real estate and see interest rates rising in the short term.
In currencies they are +ve on Poland, Malaysia and Brazil and –ve India, Indonesia and Vietnam.

SUMMARY

Emerging economies are shifting the centre of gravity of the world economy and driving world growth due to a demographic and resource advantage over the developed world. Where there was once perceived to be great risk there is now great opportunity.

EMs are still offering good value to asset managers and with huge reserves and savings they offer even greater investment opportunities.

As the majority of EM countries have many trade partners then corporate profits should continue to offer good returns across the board with maybe the Latin American countries suffering a little should the US hit a recession.

As we thought the true conclusion would be that these markets offer very good long term investment potential, though corrections will occur and so volatility should be expected. Having said that, maybe emerging markets should now make up more of a growth investors portfolio than before as there is no doubt as to the importance of these economies over the long term.

Important Footnotes:

While the author has attempted to faithfully replicate the comments of the speakers, this document should be read taking into account that the opinions quoted in isolated bites and therefore one should regard the information as general information.

This document is not intended to act as a solicitation to invest.

Part performance is not necessarily a guide to the future and the Emerging Markets can be a high risk investment.

Whilst reference has been made to capital-protected funds and stop-losses, this would be specific to a fund and therefore the protection of risk would have to be evaluated with the aid of the specific fund prospectus.

The Spectrum IFA Group is an Independent Financial Adviser and therefore has access to a wide range of investment areas, not only the emerging markets and it is accepted investment wisdom that a portfolio should be diversified and not solely invested in one area such as Emerging Markets.

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