



ANOTHER BRIC IN THE WALL

A look at the next big players
in emerging markets

By Stephen Way

As the U.S. and eurozone superpowers struggle to right themselves financially, emerging markets (EM) have been a key source of growth for the global economy in recent years. But even these markets have not been immune to weakness. While the long-term outlook for these markets is encouraging—supported by positive macroeconomic fundamentals, including rising domestic consumption and infrastructure spending—EM investors have had their confidence tested recently.

The current reality of muted global growth, volatility and uncertainty is likely to continue due to ongoing deleveraging in the developed world and financial problems in Europe. However, rising domestic consumption in EM economies will likely help offset this to some extent.

According to the July 2012 IMF World Economic Outlook Update, imports have continued to grow at a faster pace in emerging economies than in developed economies (8.8% versus 4.4%, respectively) in 2011, and this is projected to continue into 2013.

Additionally, wage increases in EM countries—such as South Africa, which had an average annual wage growth of 7% for the five-year period from 2006 to 2011—point to rising consumption trends.

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BRIC

But while import and consumption trends are strong in many EM countries, the more familiar BRIC contingent (Brazil, Russia, India and China)—long touted the next generation of powerhouse economies—is experiencing a slowdown.

India is facing fiscal and trade deficits that are not likely to be resolved quickly, and political paralysis has put many infrastructure projects on hold. For example, in 2010, the National Highways Authority of India cancelled the Goa road project because of its inability to acquire land for the project due to lack of land reform.

China, following a massive injection of liquidity during the post-financial crisis period, is attempting to address imbalances arising from capital misallocation at the private and local state levels by providing more targeted support to domestic growth in areas such as the auto sector.

Growth rates in China and India slowed considerably in 2011 and are expected to continue to decelerate in 2012, albeit at a slower pace.

In stark contrast, some peripheral economies within the EM contingent are demonstrating a new-found resilience as governments implement structural changes to stimulate internal growth. Despite the global slowdown in growth, South Africa's change in growth was only marginally affected in 2011 and 2012, according to the July 2012 IMF World Economic Outlook Update.

This variance in the deceleration of growth across the EM economies highlights the importance of why institutional investors should look beyond BRIC to bolster their portfolios.

Others to watch on the EM stage include Mexico, Thailand and South Korea. These countries in particular have exhibited positive domestic economic fundamentals, rising consumption trends, healthy savings rates and sound financial institutions. They are also highly

competitive internationally, enabling them to thrive in the global economy.

South Africa

South Africa's economy has experienced dramatic growth and transformation since policy-makers began implementing a series of reforms eight years ago. In addition to benefiting from reforms to control inflation and stabilize public finances, the country has also gained from the rising global demand for commodities. The resulting improvement in employment conditions has attracted foreign direct capital investment. Net foreign reserves (which include gold and currency) have continued to expand, reaching all-time highs of approximately US\$50 billion in February.

The region's financial institutions have been extending more credit to relatively good-quality borrowers. This growing wealth effect among South African consumers bodes well for retail spending, which has grown significantly in the last few years, and grew by 6.4% on a year-over-year basis in May. For example, Woolworths Holdings Ltd.—which operates a food and clothing business in more than 400 retail stores—is poised to take advantage of the increase in consumer spending. The positive domestic fundamentals position the firm to grow its gross sales and operating margins.

Mexico

Mexico has recently had its many positive economic attributes overshadowed by headline security concerns, and it has learned its lessons from previous crises that nearly caused the country to default on its debts. In recent years, the government has been implementing fiscal discipline and strengthening the banking system (so that it is now fully capitalized and compliant with Basel III, an international regulatory framework for banks to strengthen risk management and the ability to withstand shocks). It has also introduced reforms to enhance competitiveness, such as increasing powers for Mexico's Federal Competition Commission to combat monopolies and oligopolies.

Over the past decade, government spending on infrastructure, housing and social programs in Mexico has spurred domestic economic growth. Mexico recently refinanced its external debt at lower rates and has accumulated more than US\$157 billion in foreign reserves,

putting it in a healthy fiscal position. The government's conservative fiscal policies have also helped strengthen the peso. With steady inflation close to the target rate of 3.5%, Mexico can afford to maintain lower borrowing rates, thus putting money into the hands of consumers to redistribute into the economy.

While wage growth has not been as heated as in other EM countries, Mexico has experienced a similar evolution in consumer affordability and lifestyle changes. One company set to benefit from the rising consumption trends is Mexico's leading supplier of consumer tissue products—Kimberly-Clark de México—which has a portfolio of leading brands, including Kleenex, Huggies and Kotex. The company has achieved sales growth of 8% year-over-year and looks to gain market share as it moves into new category segments and distribution channels such as hospitals.

The outlook for Mexico is likely to improve, as the domestic sectors benefit from positive consumption and income trends while headwinds from a weak U.S. recovery and European uncertainty gradually ease.

Thailand

Following a year of devastating floods and widespread destruction to capital and infrastructure, Thailand's GDP growth could rebound strongly this year because of reconstruction spending injections from private and public institutions. The Thai government has a sound balance sheet, with a debt-to-GDP ratio of approximately 41%, which is lower than most European countries, including that of France and Spain (at 85% and 68%, respectively). Thai listed companies have also been resilient, making a strong rebound across all industries in the first quarter of 2012, according to The Stock Exchange of Thailand.

The country has benefited from China's growth and intraregional trade in Asia. But it has also learned from history. The Asian crisis of the late '90s, among other things, shone a light on deficient government and private citizens' savings levels, underscoring the need for change.

Thailand's large banks have loyal customer bases, and price competition is limited. With a healthy growth in deposits thanks to rising incomes, Thailand's third-largest commercial bank, Kasikornbank Public Company Ltd.,



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maintains a portfolio balanced between corporate and retail banking, and boasts one of the highest loan yields and spreads of any of the large Thai banks. The positive market fundamentals and declining pressures on operating expenses should enable the company to generate even higher profits.

South Korea

Dubbed one of the Four Asian Tigers, South Korea has been one of the world's fastest-growing economies since the early 1960s and is one of the most industrialized members of the Organisation for Economic Co-operation and Development. In 2011, South Korea's GDP per capita was more than US\$16,500, exceeding that of Spain, Greece and Portugal.

As a heavily trade-dependent nation—South Korea ranks among the top 10 in terms of exports and imports in the world, according to estimates from the CIA's 2011 *The World Factbook*—the country boasts companies that have dominated their home market and evolved into highly competitive businesses now set to compete on the global stage.

A perfect example is global giant Samsung Electronics, which has conquered the consumer electronics market in Asia and is a formidable competitor against Apple in the fast-growing smart phone and tablet market. According to a July 2012 article in *Business Insider*, in Q2 2011, Samsung shipped 20.2 million units of smart phones. By Q2 2012, the units shipped had grown to 50.5 million, representing an increase in global smart phone vendor market share from 18% to 35%. In comparison, Apple shipped 20.3 million units in Q2 2011 and 26 million units in

Q2 2012; its market share remained steady at around 18%.

With Opportunities Come Risks

Emerging markets offer tremendous opportunities, but investors should be aware of their risks. These markets are typically more volatile than many developed markets. This is partly due to heightened political and economic risks, as the countries transition to free-market economies and implement various reforms.

Investors must also consider the inherent risks of investing in markets with a short track record of opening up to foreign investors or investing in relatively early-stage companies. This is in addition to the usual threats of stock price fluctuations, liquidity, inflationary pressure and local currency volatility.

EM countries will likely remain key contributors to global growth well into the future. The healthy states of sovereign finances, trade balances, savings rates and employment trends have given governments in these countries the ability and resources to stimulate growth at home to offset some of the weaknesses seen globally. Policy reforms should continue to bring about structural improvements and productivity advancements, which should be positive for domestic economic growth in the long run.

Investors looking for global growth and willing to consider accepting the risks associated with emerging markets would do well to invest beyond BRIC—and gain the diversification benefits so considered vital to long-term investing. ■

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