Monthly Commentary: Emerging Markets

January 2013

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Emerging Markets in January 2013

The MSCI EM (TR) Index gained 1.4% in January, as sentiment towards global growth continued to improve. That increased confidence helped bid up the price of certain industrial commodities last month, such as crude oil, copper and iron ore. However returns for overseas investors in some markets (e.g. South Africa, Malaysia, Egypt, Kenya) were reduced by currency weakness reflecting, broadly, political concerns.

Our first trip to **Mexico** this year revealed that optimism (both amongst management and political watchers) has continued to build since our last visit in October. The *Pacto por Mexico* – a bipartisan plan of action released the day after inauguration – marked the start of President Enrique Peña Nieto's (EPN) reform agenda, which so far seems to be tracking the optimistic scenario outlined in our October note last year. Labour reform by the outgoing Calderón administration is estimated to bring nine million workers into the formal system with the associated benefits this brings, not least to the banking system.

Although naturally wary of such widespread optimism, it seems warranted. The economic expansion is arguably in its early stages (for example, credit as a proportion of GDP is less than 30%), corporate returns on capital are generally healthy but not excessive and the backdrop for industrial investment is favourable with a recovering consumer market. The obvious area of concern is the security situation, particularly in the north of the country. Yet there was little mention of this during our visit. In Mexico City the main concern was the unpredictable traffic.

A GWM Hover, ready to fly

Talking of traffic, in **China** the passenger vehicle market grew 6.8% to 14.7 million units last year, a slowdown considering the average 35% annual growth from 2009 to 2011. Roland Berger (a consultant) expects the Chinese automotive market to grow 8% annually until 2015, followed by 5% until 2020. Car penetration is low in China at 50 per thousand people and is expected to increase with rising affordability, urbanisation and improved access to financing. Over 70% of car sales in China are to first-time buyers and 90% of buyers pay in cash. Luxury cars (priced at over Rmb 400,000) and sport utility vehicles are the fastest growing categories. Luxury car sales grew at an annual rate of 58% over the last five years, and are expected to grow at least 15% per year for the next five years.

However, 2012 was a relatively tough year for the Chinese automotive industry. After three years of rapid growth, supply exceeded demand due to overoptimistic growth projections, and excess capacity in Europe was pushed into China. Excess inventory had been largely cleared by the end of the year due to heavy price discounting and, by January this year, dealer inventory levels were back to normal (30 to 45 days). There are dozens of domestic car manufacturers in China, supported by cheap capital from various local government initiatives, but they are increasingly under pressure to consolidate. The Chinese government is keen to see global auto companies emerge from China and has set a target of one million vehicles for export by 2015 (from under 200,000 in 2012). Geely and Great Wall Motors (GWM) appear to be leading in costs, quality and technology. Geely's parent bought Volvo of Sweden in 2010 and should benefit from the technology transfer. It seems reasonable to expect price erosion (so far in low single digits for old models) to accelerate as demand slows and supply continues its rapid growth.

The Chinese automotive sector faces several challenges. According to an industry survey, Chinese consumers prefer foreign brands to domestic ones if affordability is not an issue. And major cities like Beijing, Shanghai and Guangzhou have started restricting the number of new car registrations to tackle air pollution. The US Embassy in Beijing releases a daily air quality measure that on most days rates the city's air as hazardous to health. Even the state-owned media has been critical of the government's failure to combat pollution. Car companies fear that the registration restrictions might spread to other cities. In addition, China is keen to adopt global standards in emission norms which would be an additional challenge for the domestic companies.

Staying in Asia, the economy in **Thailand** grew more than 5% in 2012 and may expand a further 4.5% in 2013. Strong domestic demand and an investment recovery have allowed Thailand partially to de-link from the rest of the world. While many developed economies are trying to shrink household debt, leverage in Thailand has been gradually rising from its post-crisis low twelve years ago. The question is whether the government's pro-growth policies are fuelling unsustainable domestic demand and/or denting competitiveness. At the beginning of the year, the minimum wage rose nearly 70%

outside Bangkok, a tax scheme for first-car buyers boosted car sales 80% in 2012 to 1.4 million units and the government's controversial rice pledging scheme pays farmers above-market prices, making Thai rice uncompetitive overseas (rice exports fell 24% by value in 2012).

These issues, together with the 35% rise in the stockmarket in 2012, made us suspect the near-term outlook. However, a few things have come together to boost Thailand's potential growth rate, including strong foreign direct investment (Thailand has gained regional market share), huge investments in infrastructure (the government plans to spend US$7 billion or 20% of GDP over seven years mainly on transport) and most recently, improved confidence from relative political stability. These have lifted confidence and triggered a new capex cycle. Towns outside Bangkok are benefiting disproportionately from the growth, and some retailers, hospitals and banks have raised their upcountry investment plans even since mid-2012. To our surprise, mall operator Central Pattana said they are not near saturation even in Bangkok, and they intend to speed up the development of new, smaller malls upcountry. It is hard to measure, but the surge in spending is enormously helped by the constant rise in the number of tourists: 22 million arrived in 2012, up 16%. Tourism is Thailand's secret weapon, where the country's natural beauty creates perhaps the fastest route on earth for a poorly educated school leaver to earn a skilled service sector wage.

Still in Asia, the economy in **Vietnam** is struggling. Officially it grew 4.7% in the first nine months of 2012 but bottom-up observations reveal very weak areas; total credit growth is under 5% (this may reflect restructuring existing loans not new lending), manufacturers and distributors cannot get working capital, 50,000 small businesses closed in the first half of 2012. Rents in Saigon have halved since 2008 and construction activity is frozen (typical report in the local paper: "Quang Ninh Construction & Cement has revised down its 2012 pretax profit target by 71.12%"). The cost of bank funding can be a good indication of economic stress and in Vietnam local banks pay up to 15% for deposits, 8% above inflation.

Vietnam's downturn is home-grown and has nothing to do with global demand. On the contrary the external accounts are strong with strong growth for the major exports; furniture, rice, coffee, rubber, electronics (a quarter of all Samsung's handsets are made here; Samsung Vietnam expects US$10 billion sales in 2012). With import compression – another sign of domestic weakness – the balance of payments is in surplus and foreign exchange reserves should rise. There are two issues. Huge unsterilised capital inflows following World Trade Organisation accession in 2008 created a property boom and the state-owned enterprises have over-invested in non-core assets often for reasons other than commercial returns. Credit to GDP rose astonishingly from 40% in 2000 to 119% in 2010. Banks claim 4.4% non-performing loans; the central bank governor says they could be double that and the Chairman of the National Assembly says half of all credit could be to property. A credit crunch, distressed asset sales and bank recapitalisation look likely.

Like Thailand, Vietnam is gaining share regionally in FDI. Encouragingly, manufacturing replaced property as the largest destination of inflows in 2011, which should boost exports. Traditionally FDI does not use local bank financing (true anywhere, not just in Vietnam) so it may be able to co-exist in a parallel world if the banking sector contracts. Private sector job creation might therefore support consumer spending. The consumer sector is of particular interest because there are some good listed companies, but in Vietnam they are much more expensive than the market. The better companies will become stronger in a downturn as they plan with a longer-term perspective and take advantage of others' weaknesses. It was painful to see the difference between the advertising budget of Masan consumer group (20% of total advertising spend in Vietnam) with a family-owned packaged food company which cut its advertising budget from 4% to 1% of sales two years ago to save costs: the company is now up for sale.

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