# MARKET LETTER

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## Booming Asia and the *Other* Middle East: An Investor's Perspective

**Jim Rudd**, Chief Executive Officer

*Two years ago, we departed from our traditional Market Letter format to share observations from our chief investment officer, George Hosfield, who had visited China and India. Throughout his piece, he highlighted the unique challenges and opportunities facing a privately-held contract shoe manufacturer.*

*This spring, our chief executive officer Jim Rudd took a similar journey, this time meeting with government officials and business leaders in Dubai, Abu Dhabi, Singapore and Hong Kong. Many of the same themes, questions and observations can be found in both reports. Without a doubt, we have a clearer view of how these regions are developing. But how their growth and policies will affect the U.S. and global markets remains to be seen.*

### Asia: Hong Kong and Singapore

It was fascinating to visit Asia months after the world equity markets declined by an average of 5 percent in a single week. This sell-off, which began in the Far East on February 27, had many fearing it signaled a seismic shift in the balance of power and influence in the world. The Shanghai Composite, after rising nearly 160 percent in 2006, tumbled 9 percent very quickly and led many to believe that the Chinese equity bubble had burst.

At the same time, the Japanese yen began to appreciate against other currencies unwinding the so-called "yen carry trade." The basic idea behind the carry trade is to borrow yen to purchase potentially higher return assets in other currencies. This trade is profitable as long as the cost of borrowing yen is low and it continues to be a weak currency. It's estimated that the yen carry trade has infused about a trillion dollars in liquidity globally.

These two events, occurring almost simultaneously, coupled with a growing concern in Asia of a slowing U.S. economy, caused a stampede away from riskier asset classes. Were we seeing significant "climate change" or typical "weather patterns" that reflect market fluctuations? Given the global

equity market's strong performance since that time, I'd have to say the events of late February were most certainly the latter.

In Hong Kong, I met with James Mayfield, commercial counsel for the American Consulate General; Craig Reilly, consul for economics for the U.S. Consulate General; Dr. Victor Fung, group chairman of Li & Fung Group; and Chee Hwa Tung, former chief executive of Hong Kong. During our travels, I found the massive construction efforts to be astounding. Fueled by a seemingly unlimited quantity of low-cost Chinese labor and excessive amounts of capital from trade surpluses and foreign investment, the Chinese economy has surpassed Great Britain as the fourth largest in the world.

Globalization has certainly made countries, economies and markets significantly more connected and dependent upon each other. In Hong Kong, all eyes are on the U.S. consumer, who comprises 70 percent of U.S. annual GDP, and represents a whopping 20 percent of the world's economic output. *"If the man in trainers, jeans and a baseball cap stops buying, there is less demand for manufactured goods, which impacts all the countries that manufacture those goods,"* said Mr. Fung. *"This in turn causes a drop in demand for raw materials,"* he added, *"which is how a slight change in consumer spending can be felt through the entire global economy."*

During my meetings, there were many references to Tom Friedman's book "The World is Flat" and frequent discussions about China's long-term economic advantages as it continues to emerge into an economic and political power. Mr. Tung believes the U.S. and China are on parallel paths and share many of the same economic, social, environmental and strategic defense goals. He described the two countries as *"world partners moving in the same direction with mutual interests."* He was quick to add that although both countries may share the same direction, they are taking their own distinct path to arrive there. Much of this he attributes to the cultural differences of *"an ancient culture moving slowly while the pace of United States is rapid."* Mr. Tung also conceded that China is an emerging economy facing many challenges on the horizon.

Mr. Reilly talked about the "urbanization" of China and the socioeconomic problems the government faces. The Chinese urban population has been growing 5 percent annually since 1996, an increase of approximately 50 million people each year. This shift from rural, agrarian societies to urban communities creates a double-edged sword, according to Mr. Reilly. The shift has provided an almost unlimited low-cost labor source for Chinese manufacturers, resulting in a steady growth of commercial construction since 1996.

Even more impressive, this urbanization has created a residential construction boom. Consequently, the rapid and dramatic shift has placed enormous pressure upon city governments and their infrastructure, resulting in challenges providing adequate medical care, education, transportation and utilities.

Both Mr. Reilly and Mr. Mayfield spoke of significant pollution problems. Seventy percent of China's energy is derived from domestic coal; oil accounts for only 20 percent, but almost half is supplied from imports. Therefore, China's rapid growth has fueled their need for more oil, which has played a hand in boosting global oil prices.

Water shortages and other environmental challenges have become more serious as a result of urbanization. Because of the health hazards associated with poor air and water quality, U.S. government officials working in Shanghai and Beijing receive additional compensation. In an effort to improve air quality for the 2008 Olympic Games hosted by Beijing, Mr. Reilly speculated that all factories in the city will close, and all motorized transportation will be prohibited for two months prior to the start of the Games.

***The 25 percent of the population in China with the highest IQs are greater than the total population of North America, meaning that the Chinese have more honor students than we have students.***

*from Educator Karl Fisch*

According to the U.S. Consulate, in the 30 years since China's economic reform process began, the economy has grown at an average annual rate of 10 percent; a pace unrivaled in modern human history. Perhaps the biggest challenge will be how the government and central bank manage the economy. Although growth has propelled living standards higher, the Chinese government has tried to slow growth over the past few years in an attempt to curb potential inflation.

On April 19, China reported first quarter inflation of 3.3 percent. This is the highest reading in two years, and above the central bank's 3 percent target. The Chinese government has tried to slow growth during the past few years through the traditional tools of monetary policy, such as lending rates and increasing reserve requirements.

Mr. Tung believes that China should not be treated as an economic adversary. *"We are still a poor developing country, according to the World Bank and our per capita income is still under $2,500 per year,"* he stated. *"China is embarking on a major rebalancing, but it will take time. The underpinnings of a consumer-driven culture are key to our development."*

## The Middle East: Dubai and Abu Dhabi

I spent three days in Dubai and Abu Dhabi which are both members of the United Arab Emirates (UAE). The UAE is a federation of seven "states" that were established in 1971 following the British withdrawal, and a supreme council consisting of seven rulers governs the country.

The total population of the UAE is 4.3 million, of which 700,000 are nationals. Approximately 35 percent of the nationals are between the ages of 18 and 35, and 40 percent of the population are males. I was surprised to learn that males receive 100,000 AED (United Arab Emirates Dirham) or about $27,000 U.S. when they marry. They are also gifted land, a home with water and electricity, and an annual $2,500 dividend from the government. Keep in mind that these benefits are for the "average" male citizen, not a relative of an elite family, of which there are many. Females receive no subsidies from the government.

The two largest Emirates also happen to be cities: Abu Dhabi and Dubai. With a population of 1.7 million, Abu Dhabi is the seat of government for the UAE. It is also the center of cultural activity and a thriving tourism center. Abu Dhabi owns 95 percent of the UAE's oil and gas reserves and represents 60 percent of the UAE's GDP. With 92 billion barrels of oil in reserve, it is estimated that Abu Dhabi has enough oil to last 120 years, equaling 10 percent of the world's reserves.

Dubai, on the other hand, has only 20 years of oil and gas reserves left and has rapidly diversified its economy to become the financial center of the country as well as a tourist hub and an international sports destination. With 1.2 million citizens, Dubai is where you find the $1 billion *Burj Al Arab Hotel*, *The Palm* residential development and the *World Island* development. These epic structures are impossible to describe but I'd encourage you to look them up on the Web.

Our host in Abu Dhabi was Ahmed Saeed Al Badi, a graduate of Lewis & Clark College in Portland, Oregon. Mr. Al Badi formerly served as oil minister as well as finance minister for the UAE. In addition, he also served as the United Nation's senior officer for health. Mr. Al Badi told us that for the last 15 years, Abu Dhabi has taken half of its annual revenue from oil and gas sales and has used it operate the country. The other half has been invested internationally. For instance, they own telecom licenses in Nigeria; crude oil and gas concessions in Libya and Oman; a 5 percent stake in Ferrari; and joint ventures with many Fortune 1,000 companies to build everything from state-of-the-art hospitals to universities. In fact, their investment portfolio has become so massive that it now annually earns more from offshore investments than from the sale of oil and gas! The day after we left, the Japanese Prime Minister and 175 Japanese industrialists arrived. The purpose of the visit was to secure Abu Dhabi's commitment to supply much needed oil and gas to the island nation. Twenty percent of Abu Dhabi's annual production goes to Japan, which amounts to 60 percent of Japan's annual requirement.

***According to the CONMEX Forum, about 30,000, or one quarter of the world's construction cranes, are currently operating in Dubai.***

Whatever your impression may be about the region's wealth, triple it and you might be in the neighborhood. Since the early 1970s oil embargo, this economy, which once survived on date farming and pearl diving, has been transformed into a sophisticated, financial superpower. These two cities, in particular, have experienced a tsunami of petrodollar wealth. Abu Dhabi's answer to Dubai's $1 billion dollar *Burj Al Arab Hotel* is the $3 billion *Emirates Palace*. Mr. Al Badi told us that half the hotel is used for paying guests and the other half is used by the government to host official visitors, like the Japanese delegation.

Keep an eye on the UAE and other oil wealthy nations. They recognize that the U.S. is making efforts to reduce dependency on oil from the Middle East. As a result, they are investing heavily internationally. The Abu Dhabi Investment Agency (ADIA) is a classic portfolio investor in global markets and has long been recognized as the most successful sovereign investor in the Arab world.

Abu Dhabi has aggressive cultural aspirations. They've invested billions of dollars on deals with the Louvre and the Guggenheim museums and have completely pre-sold an entire city with additional museums, performing arts centers and convention centers, before the first spade of soil had been turned. I was surprised to learn that Russians comprise approximately 30 percent of the current tourist trade and even more surprised to learn that Iran is currently the largest foreign investor in Abu Dhabi.

## Conclusions

As an investor, and someone who makes decisions about where to best invest capital, one could not come away from a trip like this without a strong impression that the investment implications of all of this growth are manifest. It has certainly reinforced my confidence in the "pro-cyclical" tilt of our portfolios. The rip-roaring growth in both of these booming yet different and distinct regions will spill over into many of the sectors and portfolio companies that we own. Seeing this growth first hand only strengthens my conviction in this regard. The demand for raw and basic materials from these cauldrons of boom will continue apace for many years to come. In my mind, these investments continue to be *secular themes*, and not *cyclical* bets in nature.

To what extent we can more directly invest in these areas will require further work on our part. There are many that have likened the Chinese financial marketplace to a glorified casino. I must say there is much to that claim. While the rewards have been great to date, the risks may have multiplied dramatically of late.

We have not heard the last from either of these regions, to be sure. Seeing life first hand always broadens and sharpens your perspective. While it may not make you a better investor, it can certainly make you a more confident one.

# Investing Internationally

**Ralph Cole**, Senior Vice President

It is impossible to read Jim Rudd's piece and not get excited about the opportunities for international investing. You are first and foremost struck by the vast potential for wealth that can be created from this global boom. But as stewards of our clients' assets, we must be mindful of the perils of growth run amok.

Our international portfolios invest in mainly American Depository Receipts (ADRs) traded on U.S. exchanges. They are low cost and are required to adhere to U.S. generally accepted accounting procedures (GAAP). We also currently own two Exchange Traded Funds (ETFs) that allow us access to markets not readily found in the ADR universe. They are the MSCI Emerging Market iShare and Wisdom Tree's Japanese small-cap ETF.

There are numerous ways we are taking advantage of global growth for our clients. As in our domestic equity portfolios, we have several themes flowing through our international strategy. In Rudd's conclusions, he refers to a cyclical tilt with an eye toward infrastructure and commodities making sense to us at this time. We are also seeking profitable ways to invest directly in some of these booming emerging markets.

What countries and industries benefit from an insatiable demand for commodities in China? One of the most resource-rich countries in the world is located just southeast of China. Australia has been one of the largest beneficiaries of China's economy, from metals and mining to banking. Another resource-rich country is Canada, with its huge annual oil production. Although they may not ship directly to China, Canadian companies are still profiting handsomely from higher commodity prices. We've owned several companies from both of these countries in recent years.

"Change at the margin" is one of the most powerful forces in investing. Although it suggests different things to various countries, we try to identify changes that are occurring for the better across the globe. For example, in recent years we have witnessed dramatic changes in Germany's labor laws, allowing companies to be more flexible and cost-conscious with their workforce. France just elected a new president who ran on an investor-friendly platform of employment flexibility and lower taxes. These changes were motivated by a need to

compete with other countries within the European Union, as labor and capital has become more fluid on the continent. Japan is a country that exited its long deflationary spiral in recent years and has experienced sustained growth for the first time in two decades. Japan's recovery can be directly linked to the benefits of being in close proximity to China.

The third theme in our portfolios is investing directly in emerging markets, from China to India to South America. Surprisingly, many of these countries have stocks with lower valuations and higher yields than their global counterparts, due to the perceived risk associated with these companies. However, the "risk premium" associated with many emerging economies is actually *lower today* because of their current account surpluses. Historically, many of these nations have been debtor nations, but now *they are lending to us!* Caveat Emptor is the golden rule when investing in these often volatile markets. However, we continue to find opportunities from Brazil to Luxembourg. We are making every effort to continue increasing our portfolios' exposure to emerging markets in the coming years.

As we look out over the horizon, we know that our international portfolios will likely be our most dynamic. Investing internationally, we will be forced to balance risk versus reward, growth versus value, and comfort versus safety.

Although we have managed international portfolios since 1994, it "feels" different for us in 2007. The world is changing rapidly and we have reached a tipping point where the U.S. is no longer the undisputed leader in every industry. Our goal is to harness these opportunities in the most profitable and appropriate way possible for our clients.

*We welcome your thoughts and feedback on our Market Letter. Contact us at (503) 226-1444, or email us at info@fergwell.com.*