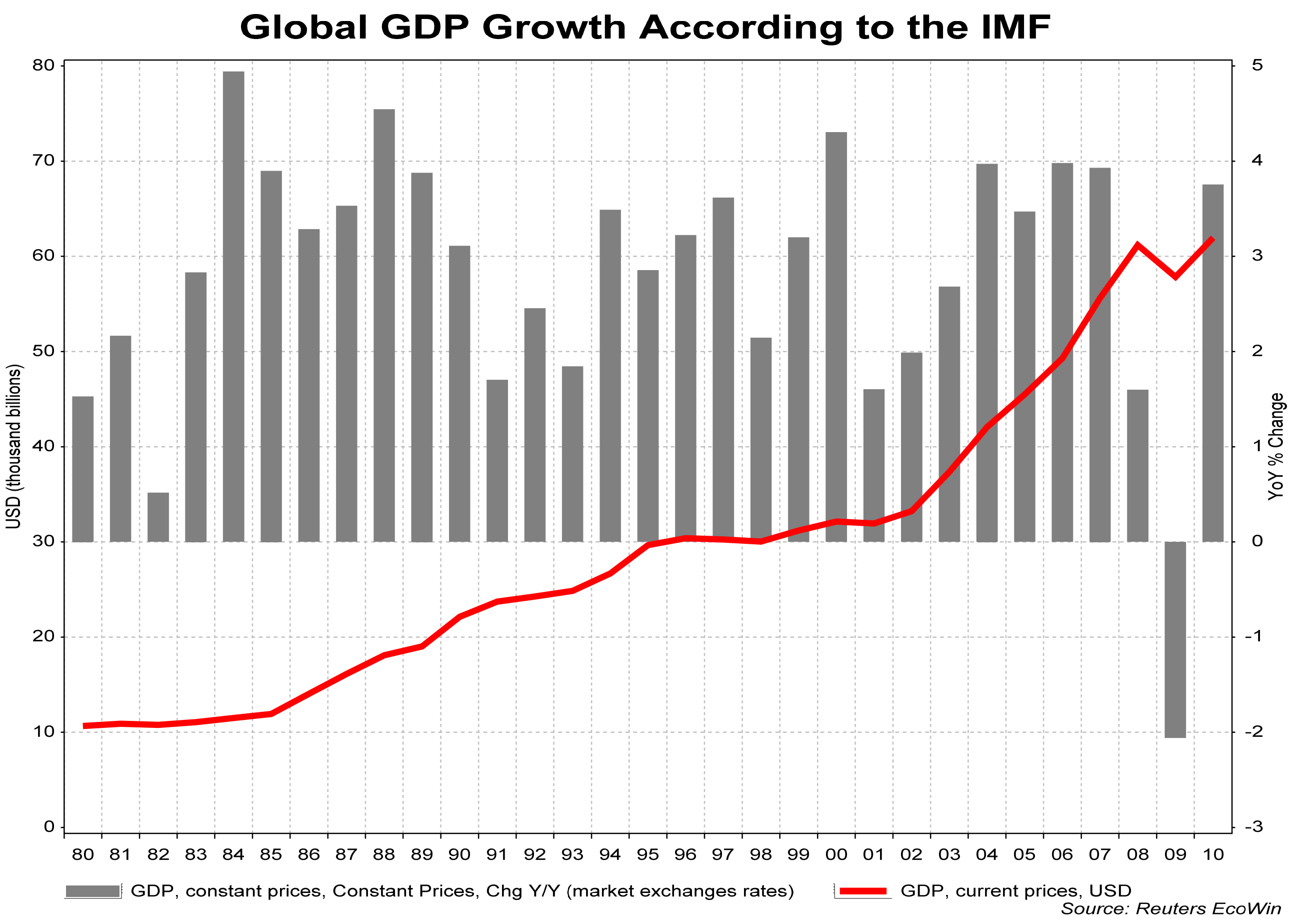
MW GAVEKAL

Investor Conference Call
Emerging Market Growth vs Developed Market Value
December 2010

Global Growth Has Come Back Strongly



- According to the IMF, global GDP growth is now almost back to 4% (which counts as a boom) and overall global nominal GDP is basically back to the highs of early 2008.

But Today's Growth Has Come With Record High Dispersion

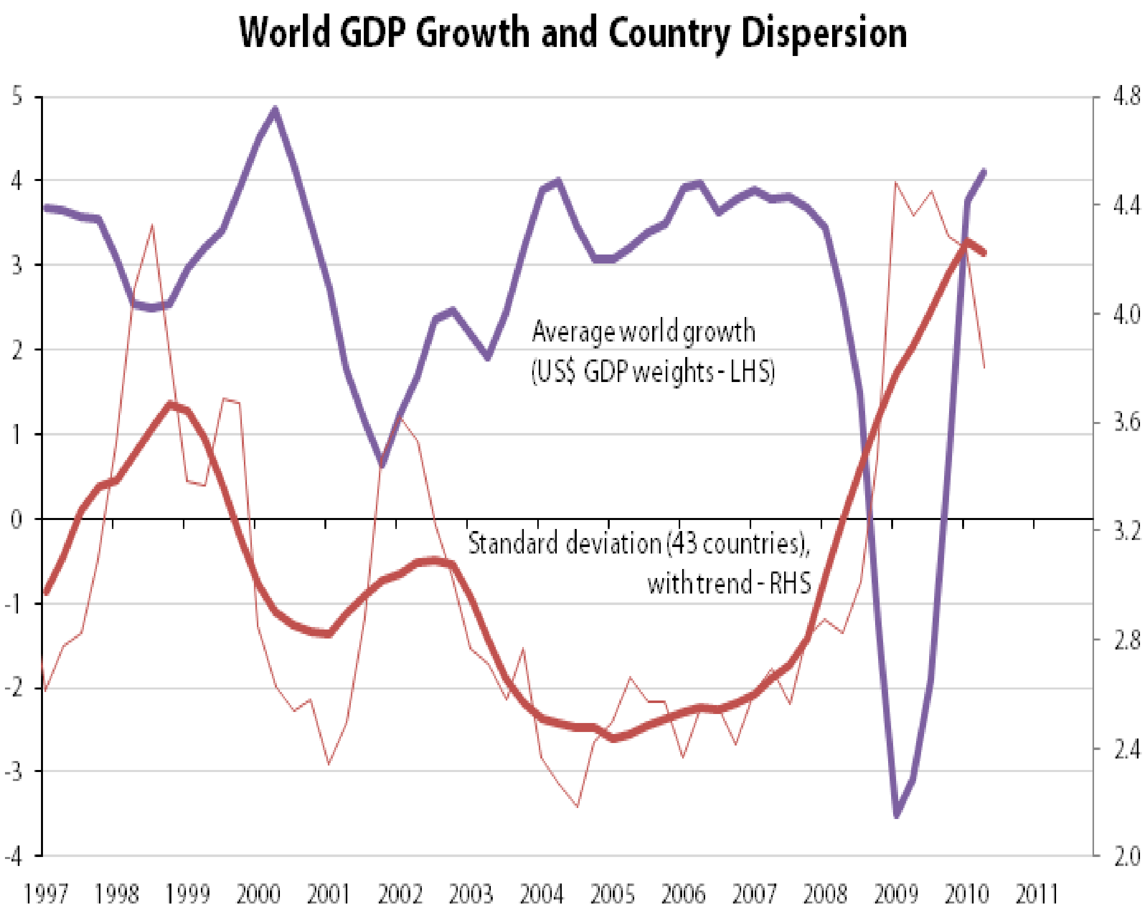


Chart note: Average world growth includes OECD, BRICs, Indonesia, Taiwan, Argentina & Saudi Arabia.

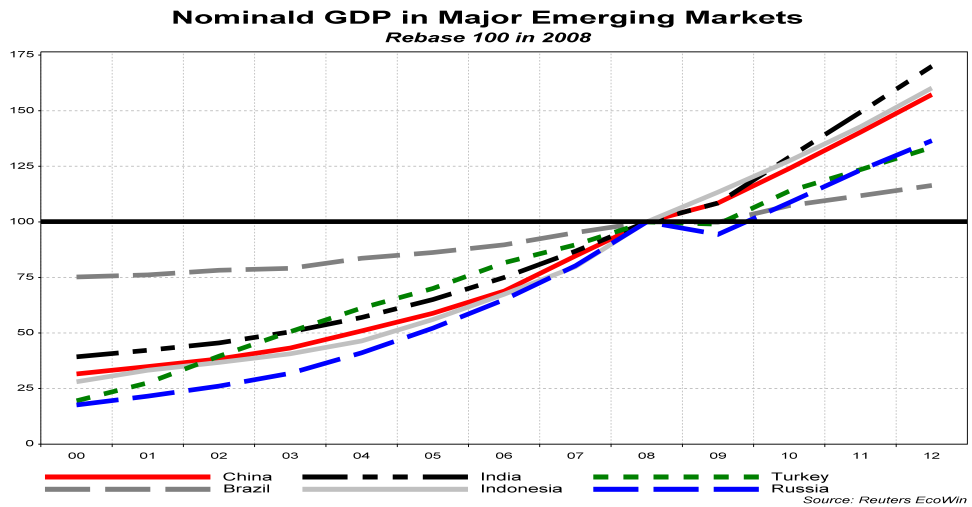
- The global economy is back to growth… but not like before; last time around, +4% global growth, triggered feelings of global prosperity because dispersion was low.
- These divergences result from the excesses of the previous decade, when growth rates were too much aligned by the effects of currency manipulations and world financial flows.
- This dispersion begs a number of important questions. Specifically:

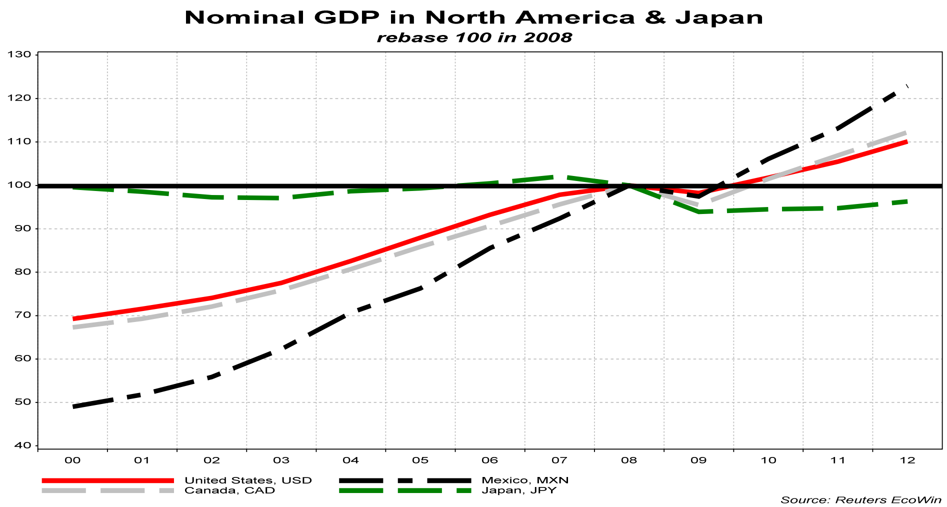
1)How are financial market participants reacting to this new environment of growth dispersion?

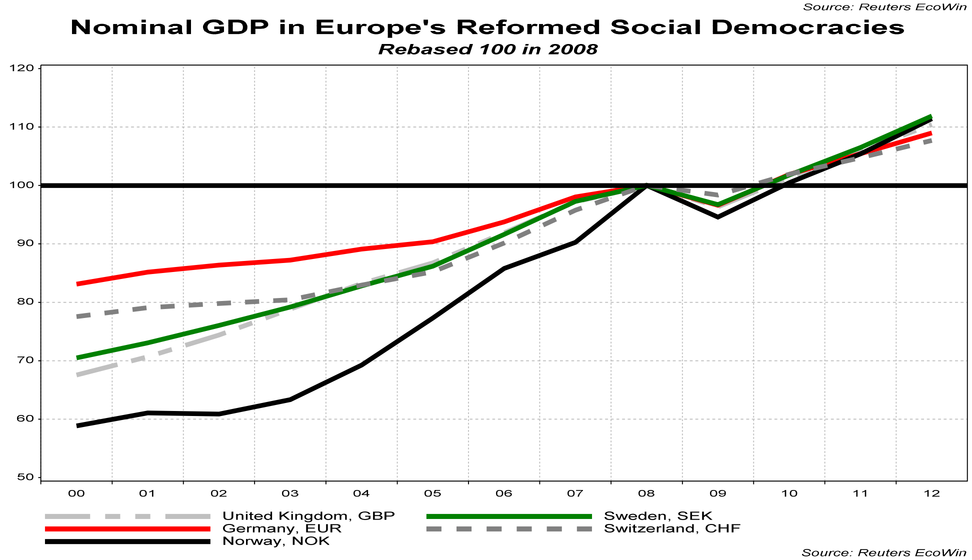
2)How will policy-makers react to this environment of record-high dispersion?

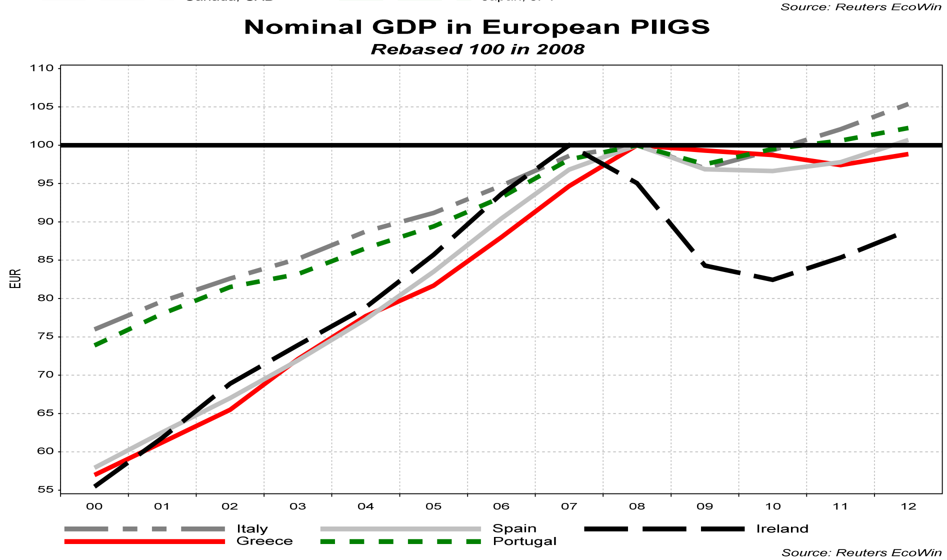
Source: MW GaveKal / GaveKal Research

The Visible Growth is Clearly Coming From Emerging Markets









Source: MW GaveKal / Reuters EcoWin

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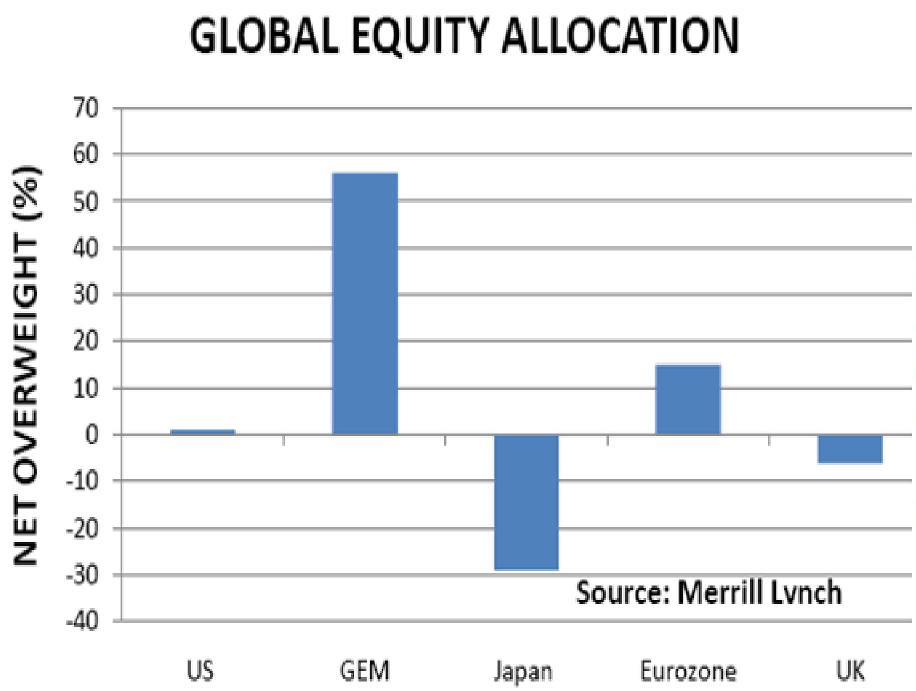
Growth Dispersion Is Leading to Record Policy Dispersion

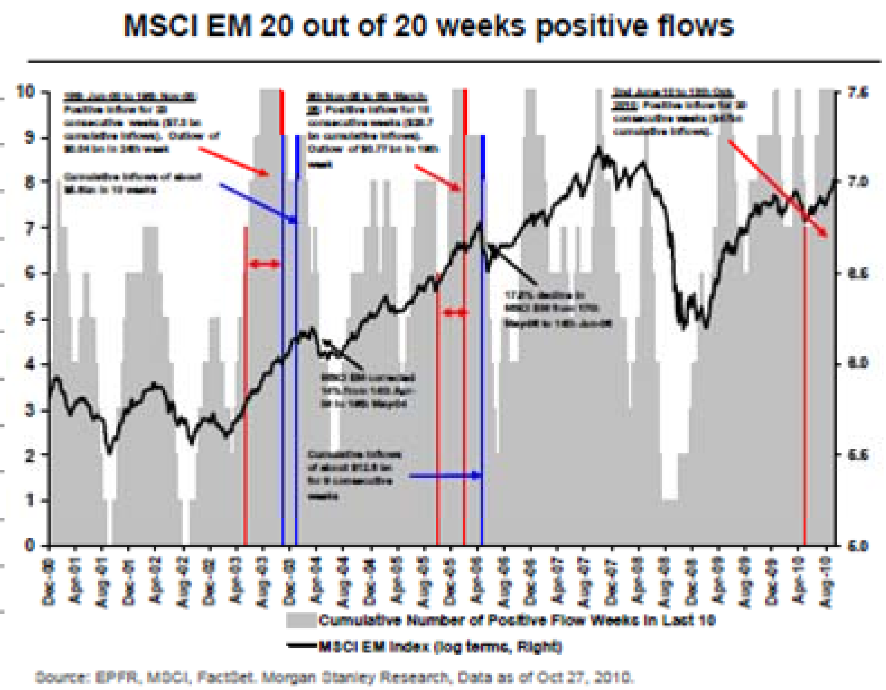
Recent Key Changes in Developed Markets	Recent Key Changes in Emerging Markets
USA Quantitative Easing	China, Korea, India, Malaysia… raise interest rates
EMU bailout of Ireland	China raises reserve requirements
Japan FX intervention and Quantitative Easing	Brazil introduces taxes for foreign investors
France raises retirement age	South Korea imposes taxes on Korean bond earnings for foreigners
UK austerity budget	HK institutes tightening measures on real estate
Switzerland intervenes to curb strength in CHF	Very high levels of IPOs across emerging markets

- No wonder the G20 did not amount to much; given the record dispersion in growth, the various countries came in with very different priorities and concerns.
- In China, the main concern is now inflation, what with food prices shooting up, labor costs on the rise, a property bubble starting to form etc… In the US, the main concern remains jobs, or the lack thereof… In Europe, the main concern is financial stability and avoiding a debt crisis.
- So while in 2008, monetary and fiscal policies were simultaneously easy all around, we are now entering a period where divergences in policy will prevail. And needless to say, this makes deploying capital that much more challenging.

Source: MW GaveKal

In the Face of Tightening, Investors Are Piling Into Emerging Markets

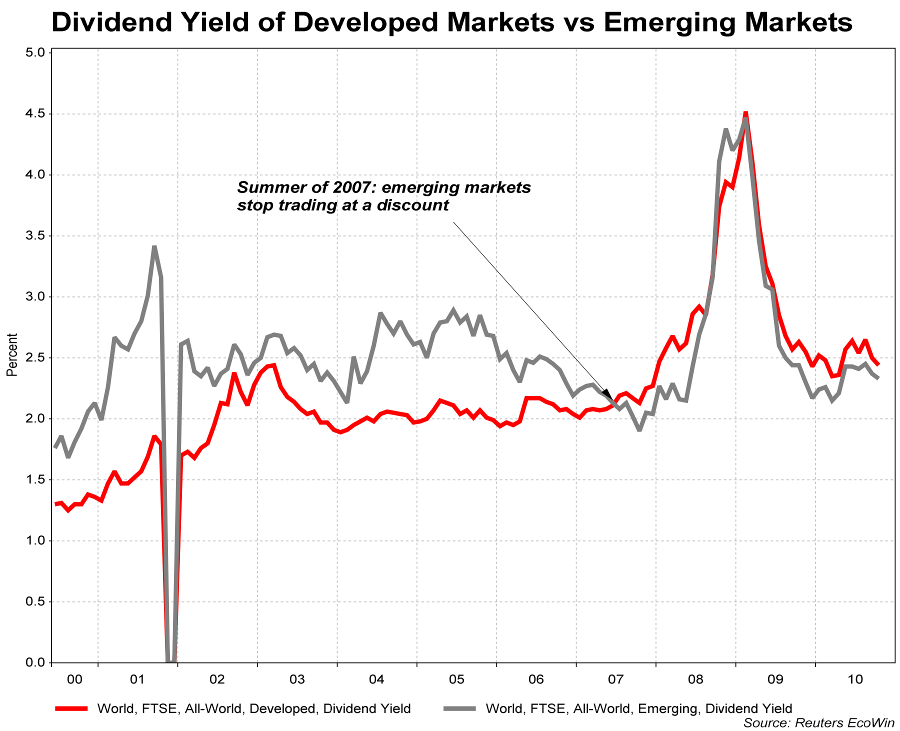


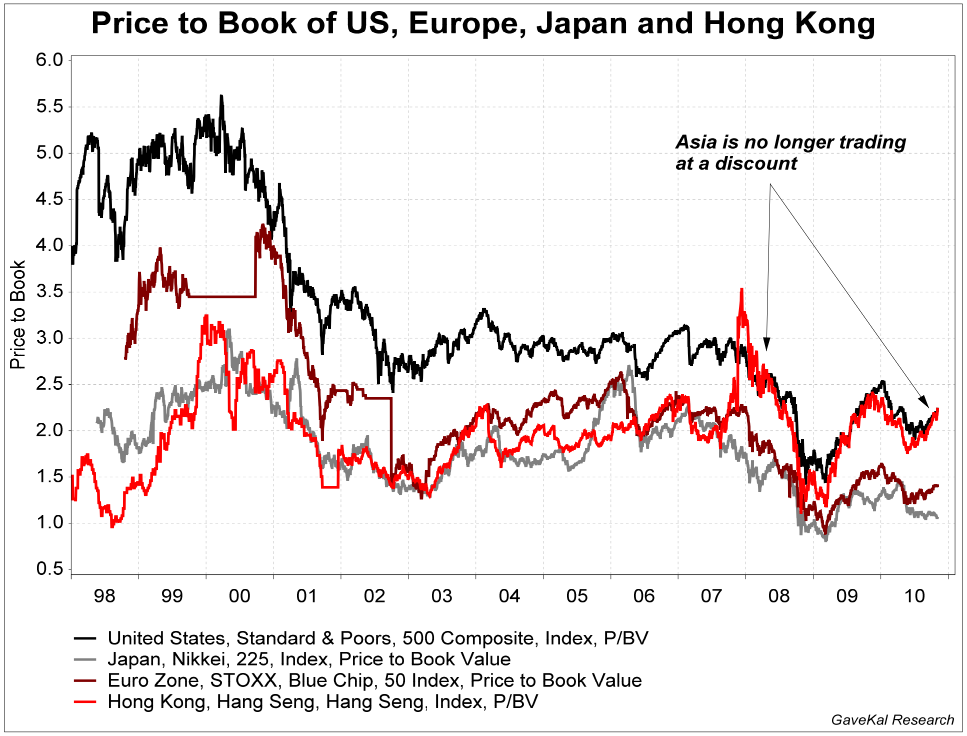


- Who does not like emerging markets today? Undeniably, this is where the growth in the world is coming from. And despite their growing economic clout, emerging market equities still represent a small part of global indices and global portfolios.
- Nevertheless, one concern has to be that policy risk in emerging markets keeps on growing by the day while in developed markets, policies usually remain a tail-wind for asset prices. **In emerging markets, central banks want asset prices to stop rising. In developed markets, central banks want asset prices to rise. So which way should we bet?**

Source: MW GaveKal / Merrill Lynch / Morgan Stanley Research

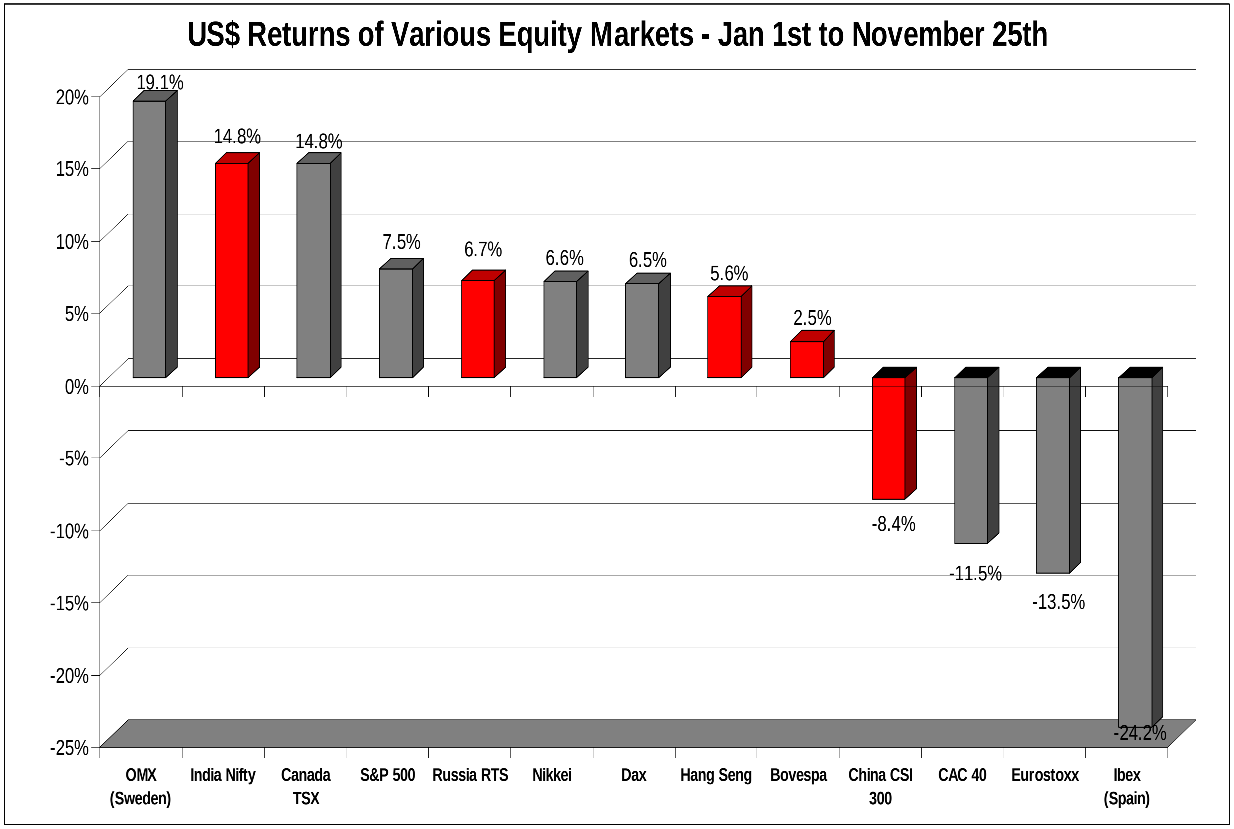
To the Point Where Emerging Markets Now Trade at a Premium





- Like moths to a light, the prospect of stronger economic growth is attracting investors to emerging markets. To the point where **most emerging markets are now trading at a premium to developed markets.**
- Given the greater individual company risk, and the greater policy risk, of emerging markets, this is a noteworthy development which must reflect either great fears about developed markets, or great hopes about emerging markets.

The EM Story is Drowned Out by the ‘Return of Country Risk’

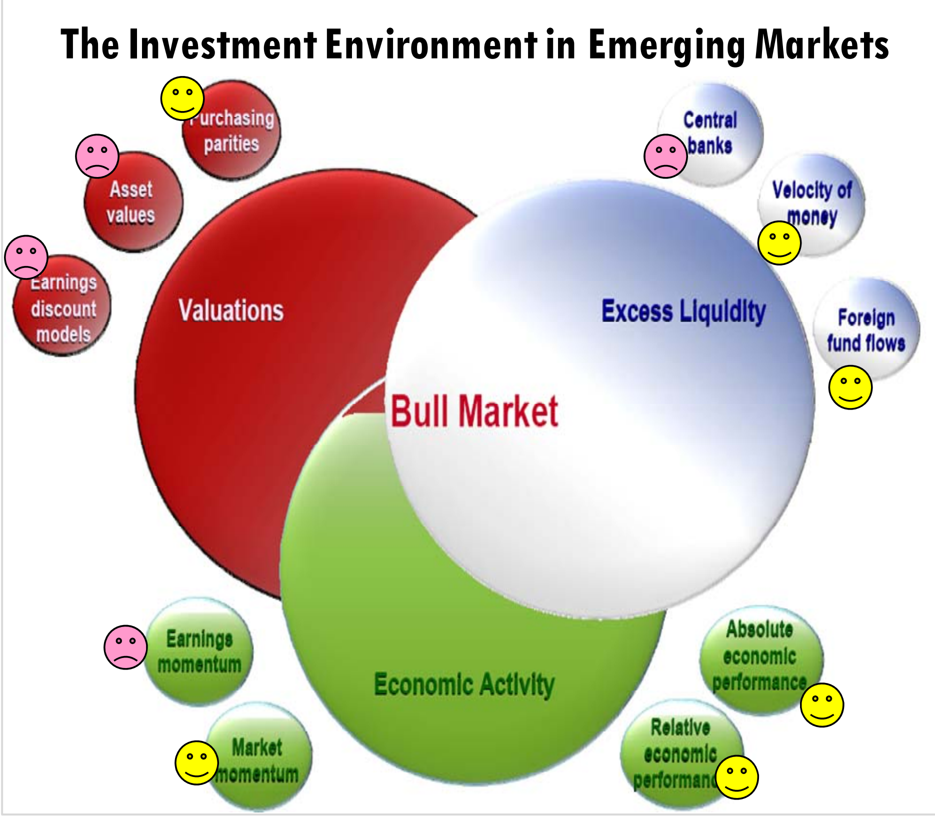


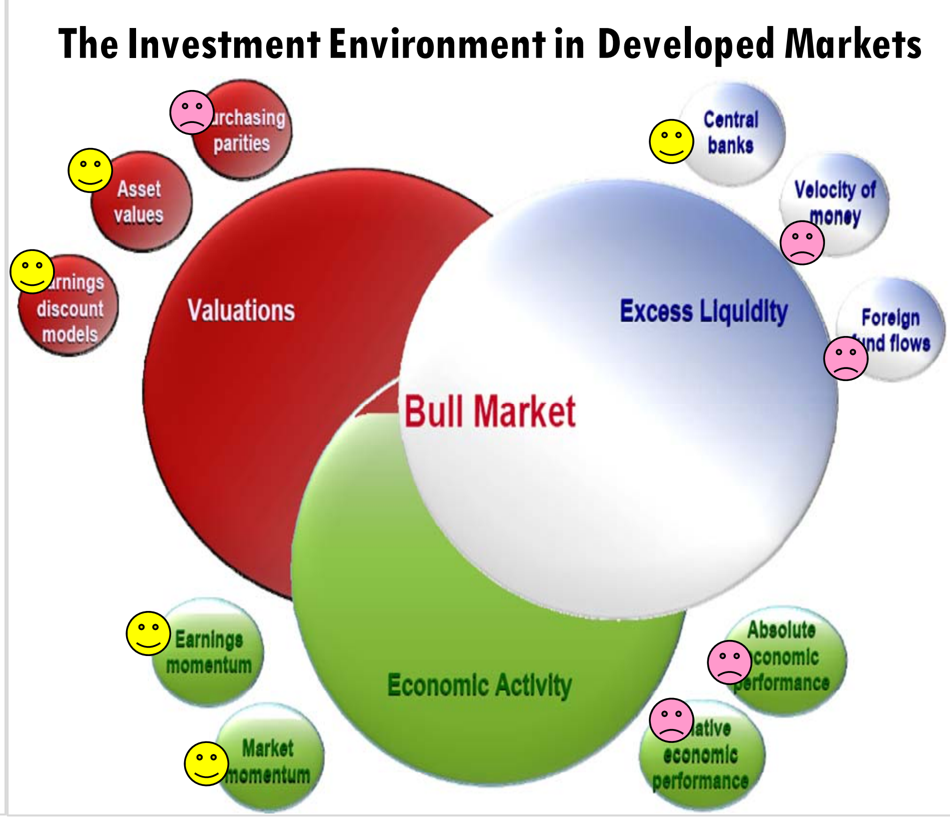
- Emerging markets have undeniably benefited from heavy investment flows.
- Interestingly, however, on a year to date basis, aside from India, the outperformance of the major emerging markets is somewhat limited.
- The year to date performance of various markets brings us back to the theme of our first quarterly of the year, **namely the return of country risk.**
- Look at the divergence between China and India. Or more shockingly, between Sweden and Spain. Or even between France and Germany…

Source: MW GaveKal / GaveKal Research

Diametrically Opposed Environments For Emerging & Developed Markets

- In emerging markets, valuations are not yet stretched but neither are they that attractive. Economic growth is solid and as a result, foreign fund flows are very strong. However, one concern might be that policy risk is accelerating, what with threats of capital controls, tighter monetary and fiscal policies etc…
- In the Western world, the opposite situation prevails: growth is perceived to be weak but assets are very cheap and investors should face little policy headwind.



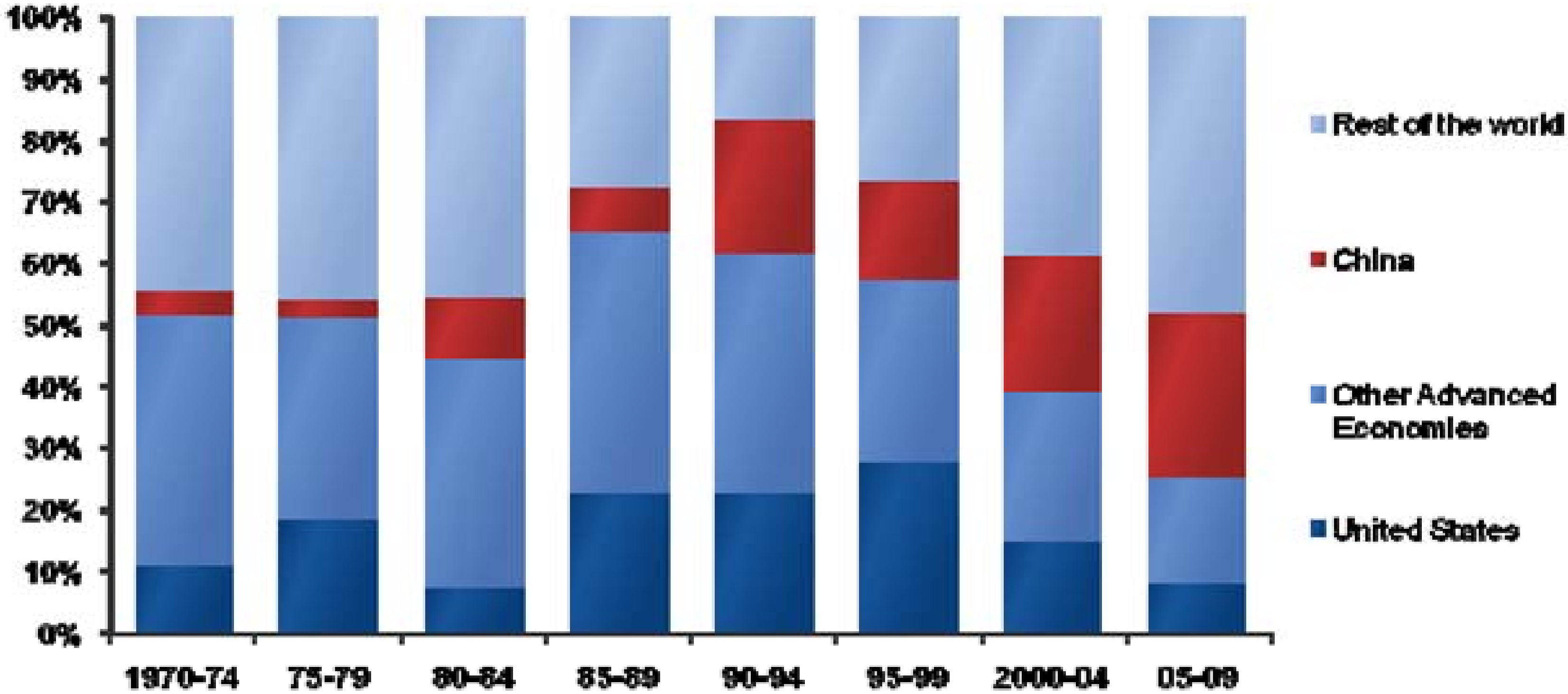


Source: MW GaveKal

1) The Reason Investors Like Emerging Markets is Obvious Enough:
Highly Visible Sales Growth

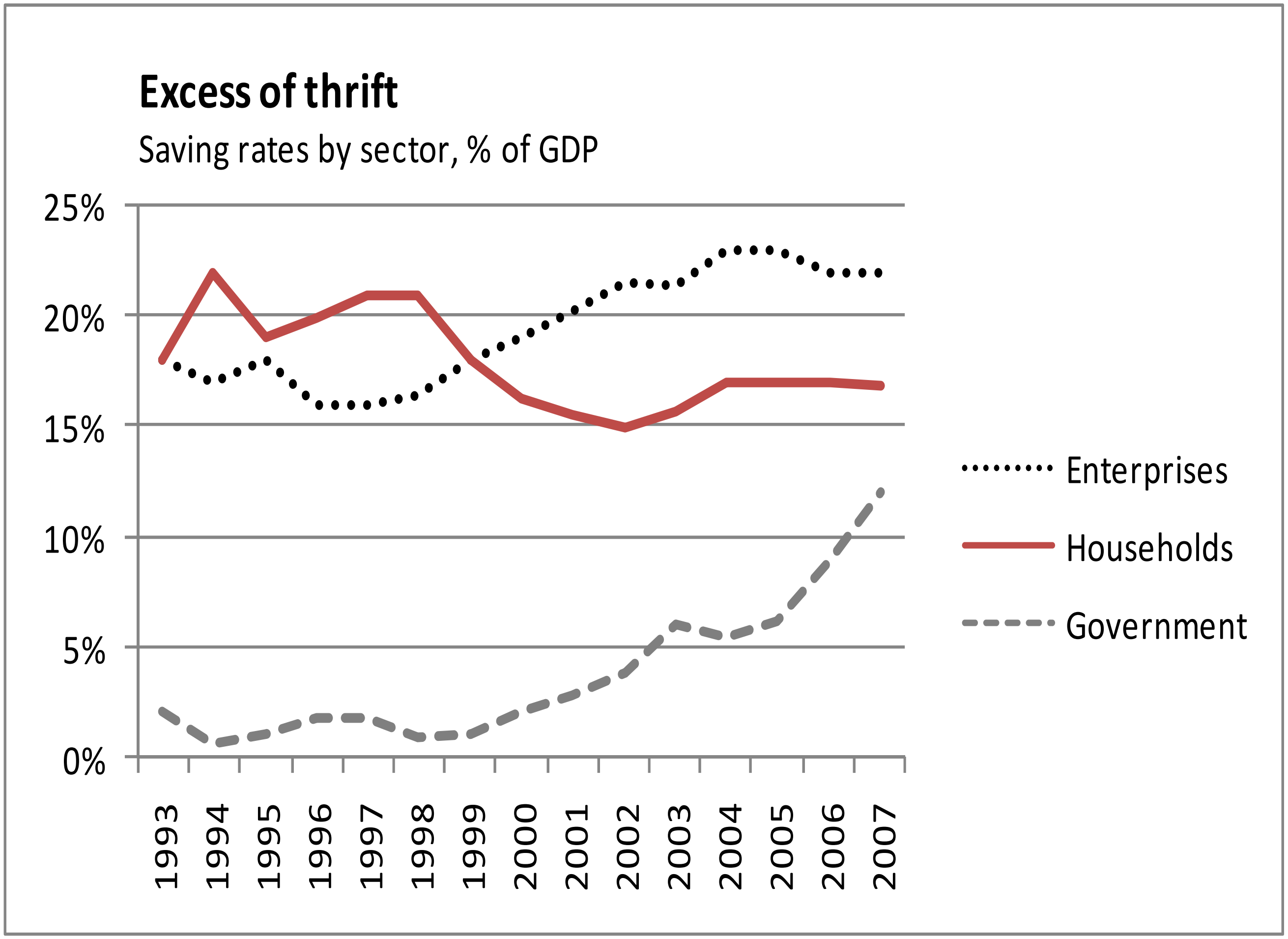
Undeniably, Global Growth is Now Driven by Emerging Markets

China is Currently the Single Largest Contributor to Global Growth



Source: MW GaveKal / www.census.gov

Excitement for Emerging Market Comes From Growing China Consumption



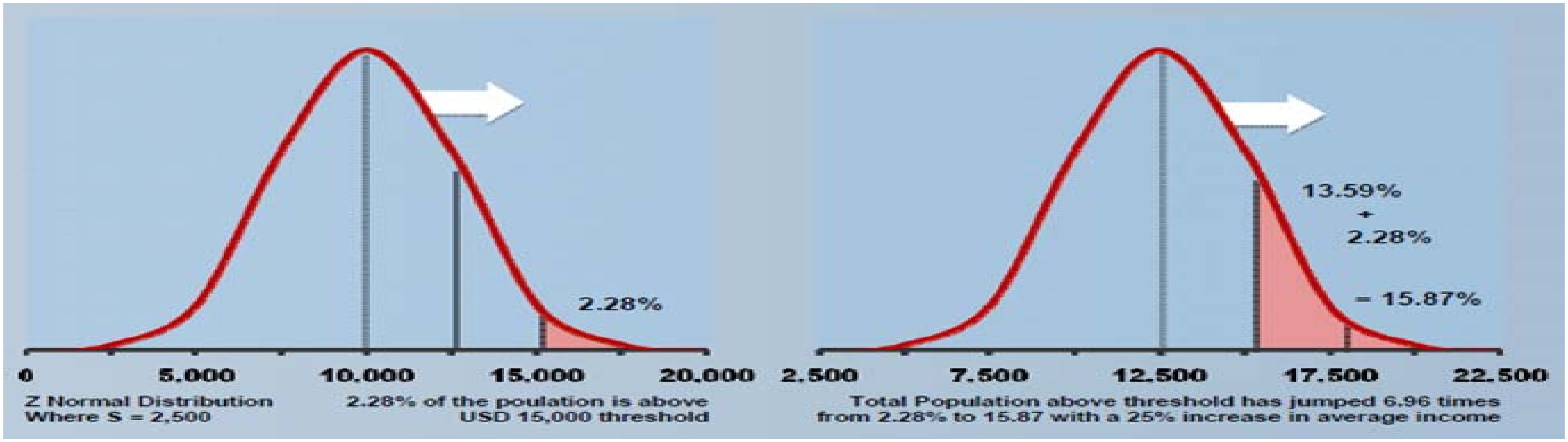
- In a country like China, national savings rates are high because of excessive savings by government and enterprises, not households.

- The reason consumption in most emerging markets is so low is not that people there are 'ants to the Western world's grasshoppers'. Households in emerging markets consume little not because they save too much, **but because they earn too little.**

- **With the rise in labor costs, this is now changing.**

Source: MW GaveKal / Professor Bai Chongen

The Acceleration Phenomenon Should Kick Into Gear



• The concept of Acceleration was first developed by Aftalion, a French economist. Aftalion explained that most socioeconomic variables are distributed according a bell-shaped curve. This means that a large percentage of the population has an income close to the 'average' income. There will be few people with a very low income and few with a very high income. And the reason this matters is that the consumption of a number of goods and services occur around key 'threshold points'.

• For example, if the average income in a country is below US$1,000, very few people own a television; when the income moves above US$1,000, then almost everybody buys one. For cars, the number is closer to US$10k per annum, for higher education, US$15k per annum, for foreign travel US$20k per annum, for financial services, US$30k per annum. Thus, as incomes gradually increase thanks to economic growth, the demand for certain goods can rise considerably in a short period of time.

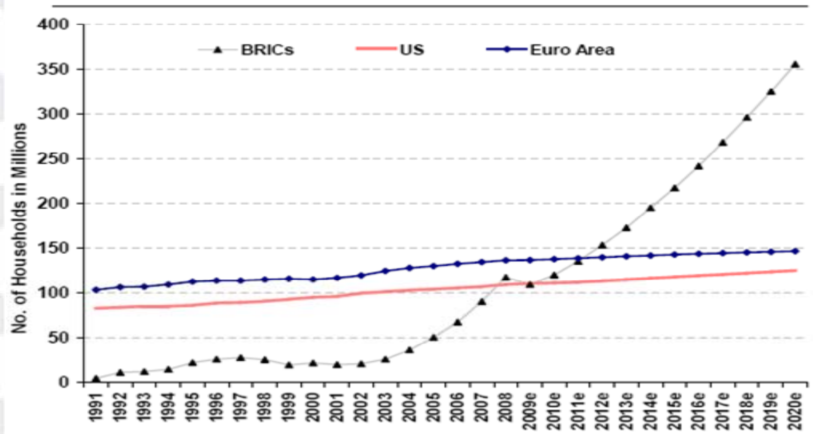
• This trend can be further accentuated by a concomitant fall in prices (eg cell phones in China). At such times, we have a 'double acceleration phenomenon' and the markets typically get very excited as valuing companies becomes very challenging.

Source: MW GaveKal / GaveKal Research

The Acceleration Phenomena in Some Concrete Numbers

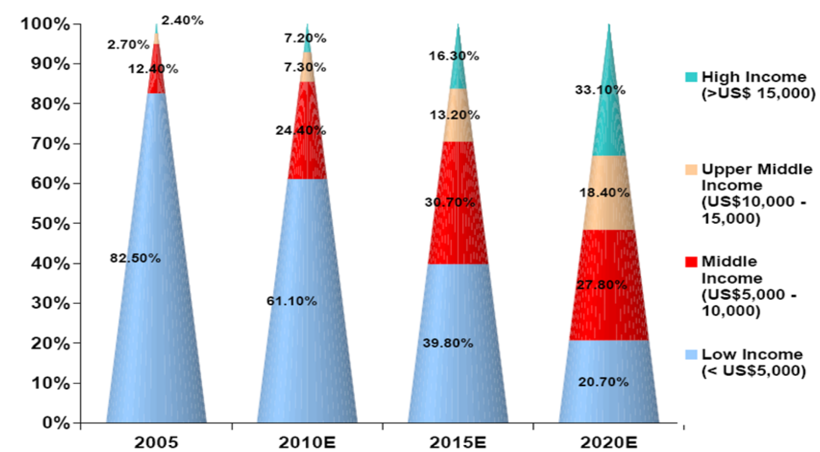
700,000	Engineers graduate annually from schools in China
53,000	RMB is the average cost of a license plate in Shanghai
40,000	Cabs drive around Shanghai daily
30,000	Chinese MBA students were expected to graduate in 2008. The number in 1998 was 0
649.7	Million mobile phones were in circulation in China in 2008
500	Coal-fired power plants to be built in China by the next decade
160	Cities in China with populations that exceed 1 million. There are 9 in the US and just 2 in the UK
97	New airports to be built in the next 12 years, bringing the total number to 244 by 2020
80	Percent of the world's zippers are produced in the factories of Qiaotou city in Zhejiang Province
80	Percent of the world's toys are made in China, in more than 10,000 toy factories
70	Percent of the world's pirated goods come from China
50	Percent of the world's pork is eaten in China
34	Children are born every minute in China
30	Percent of Chinese adults live with their parents
30	Nuclear power plants currently being built in China
6.3	Million passenger cars are registered in China. The number in 2004 was 2.4 million
5.7	Million students graduated from Chinese universities in 2007. The number in 1977 was 270,000
5	Million Chinese are estimated to visit ski resorts this year. Ten years ago, only 500 people in China could ski
1.8	Is the average number of credit cards owned by a person in Shanghai

Household Disposable Income over US$10,000



Source: Euromonitor, Morgan Stanley Research. *Forward projections are Euromonitor Estimates

China Household Income Distribution



Source Euromonitor, Morgan Stanley Research

Source: MW GaveKal / *The Beijing Axis* / Morgan Stanley Research

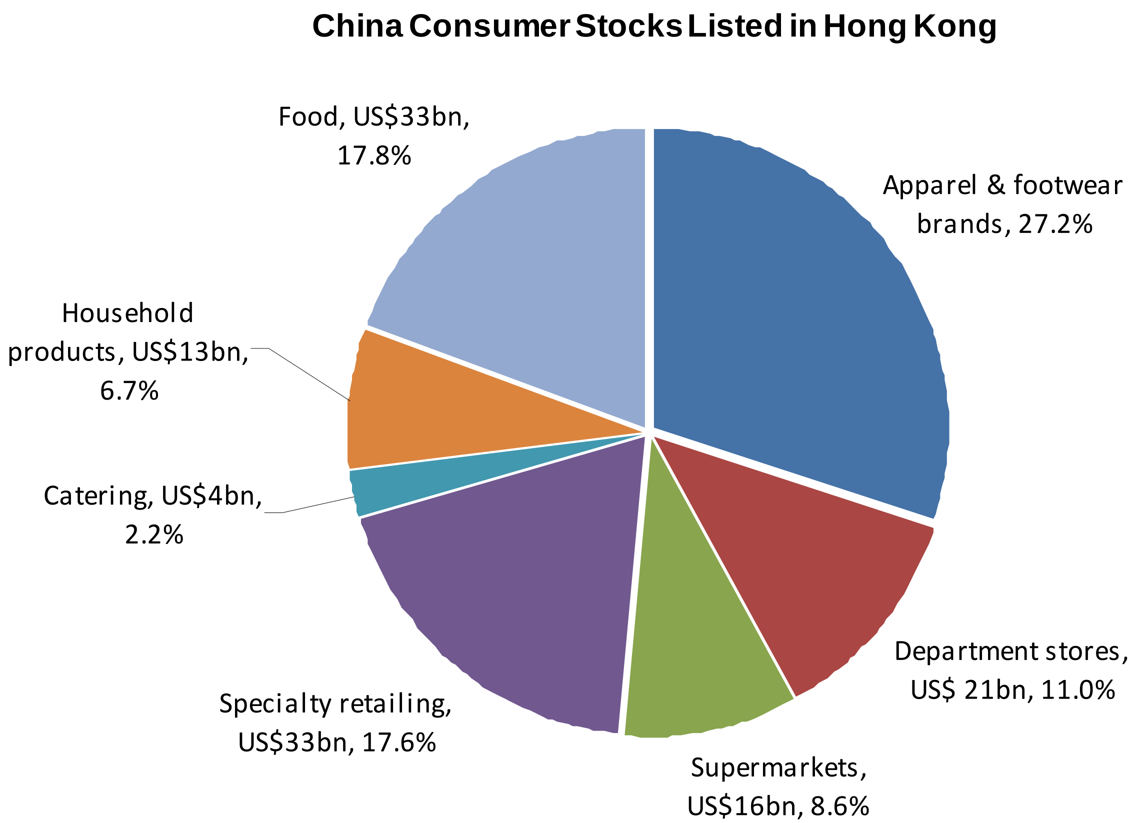
With Infrastructure Rollout Countries Are On Cusp of Massive Transformation

Source: The Beijing Axis

- Today, 65% of China's global trade depends on just four provinces (Guangdong, Shanghai, Beijing and Jiangsu).
- And 90% on just nine (out of 31) provinces.
- This is set to change in next two years as all of a sudden 90% of Chinese population will live within one hour drive of a motorway and fast speed railway lines.
- The improvement in infrastructure should lead to a collapse in logistics costs (passed on to the consumer).

Source: MW GaveKal / *The Beijing Axis*

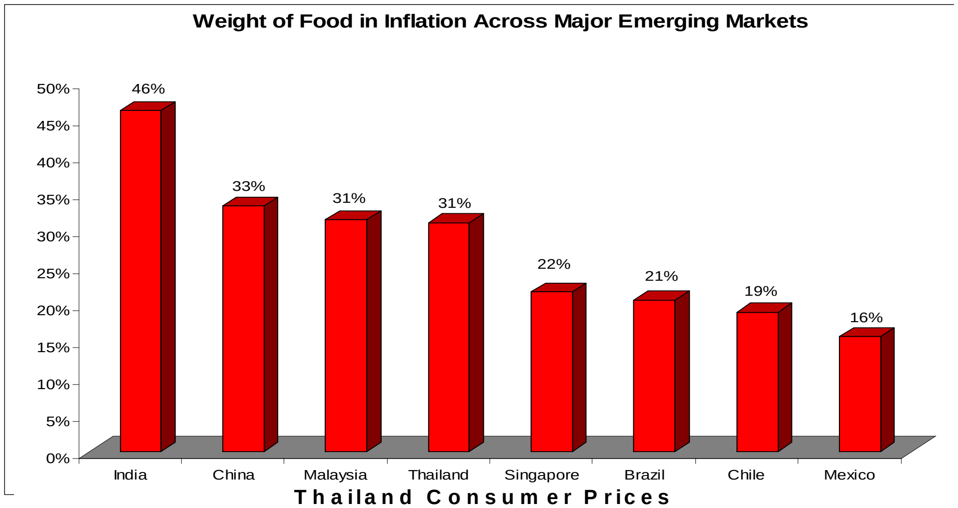
Are Chinese Consumer Related Stocks the Next Big Great Bubble?

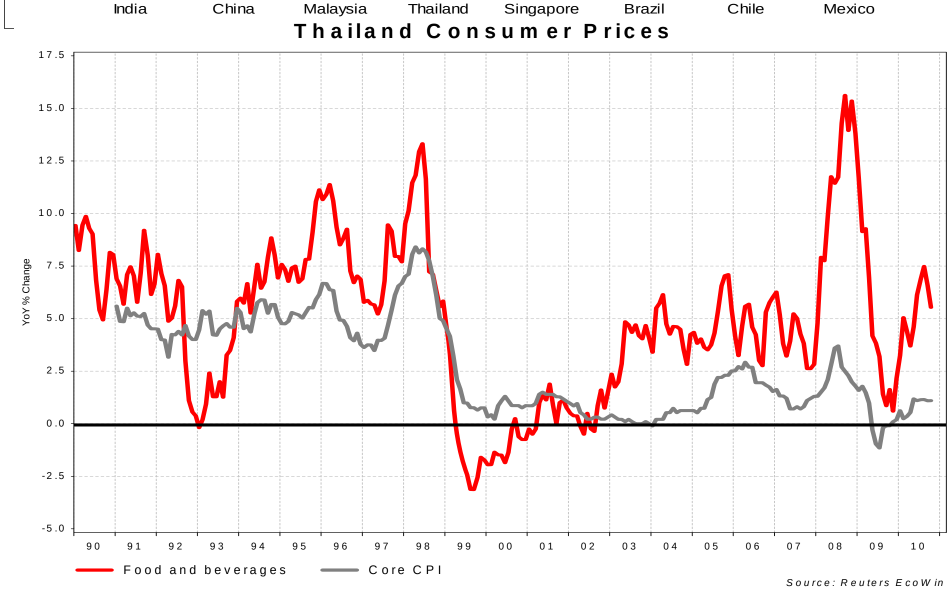


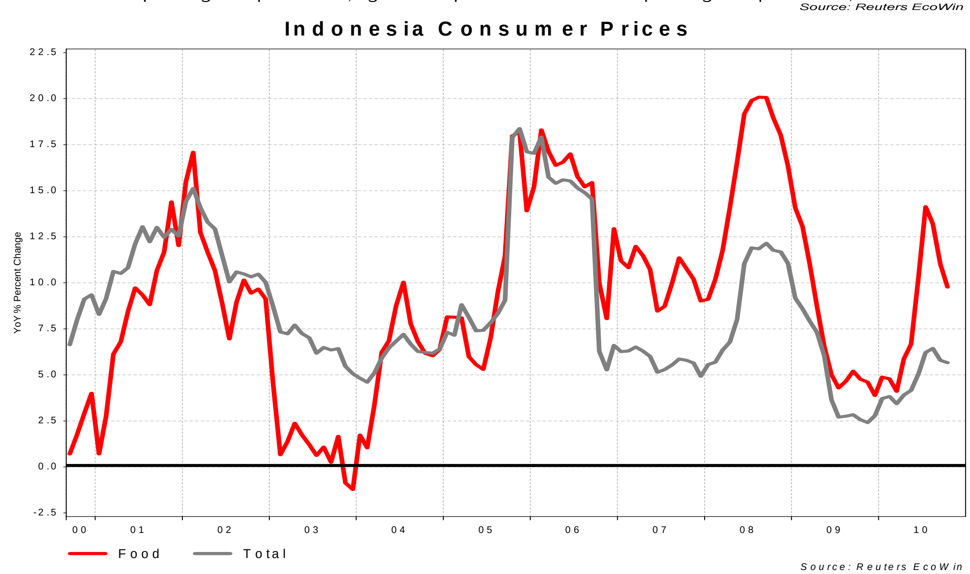
- For a bubble to develop, one needs excess liquidity, growth, and a theme to capture investor's imaginations.
- Arguably, on Chinese consumer stocks, all three are present.
- And there is also an additional kicker: the space is actually very limited compared to the opportunity set.
- **Adding up the market caps of the HK listed Chinese consumer stocks, one finds a market cap that is smaller than that of China Construction Bank!**
- And against that, every PM in the world wants exposure to Chinese consumption stories…

Source: MW GaveKal / GaveKal Research

The One Very Visible Threat to the EM Story is Food Inflation

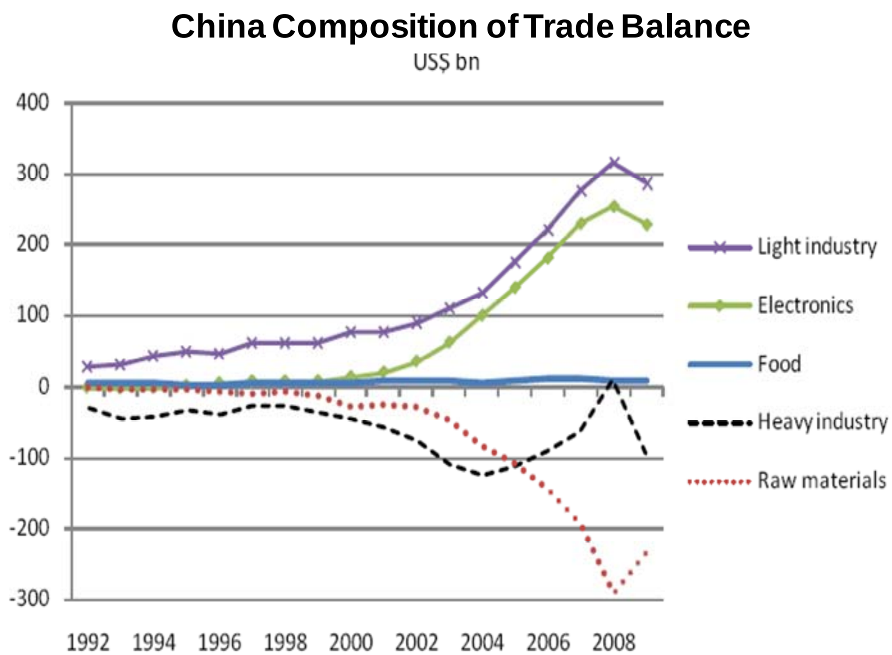


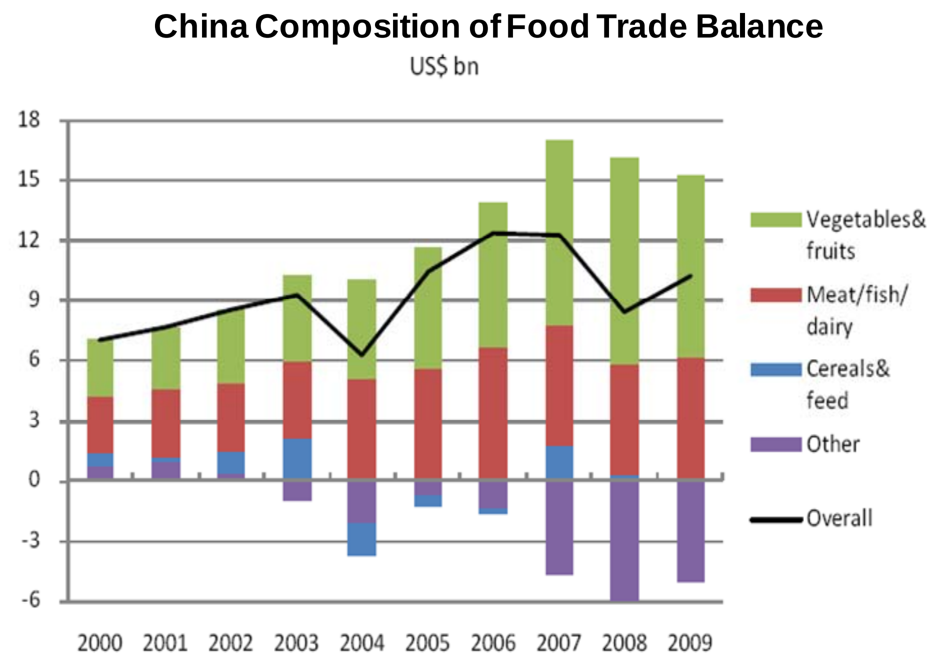




Source: MW GaveKal / Reuters EcoWin

Food Price Inflation May Be Given Structural Boost by China Changes

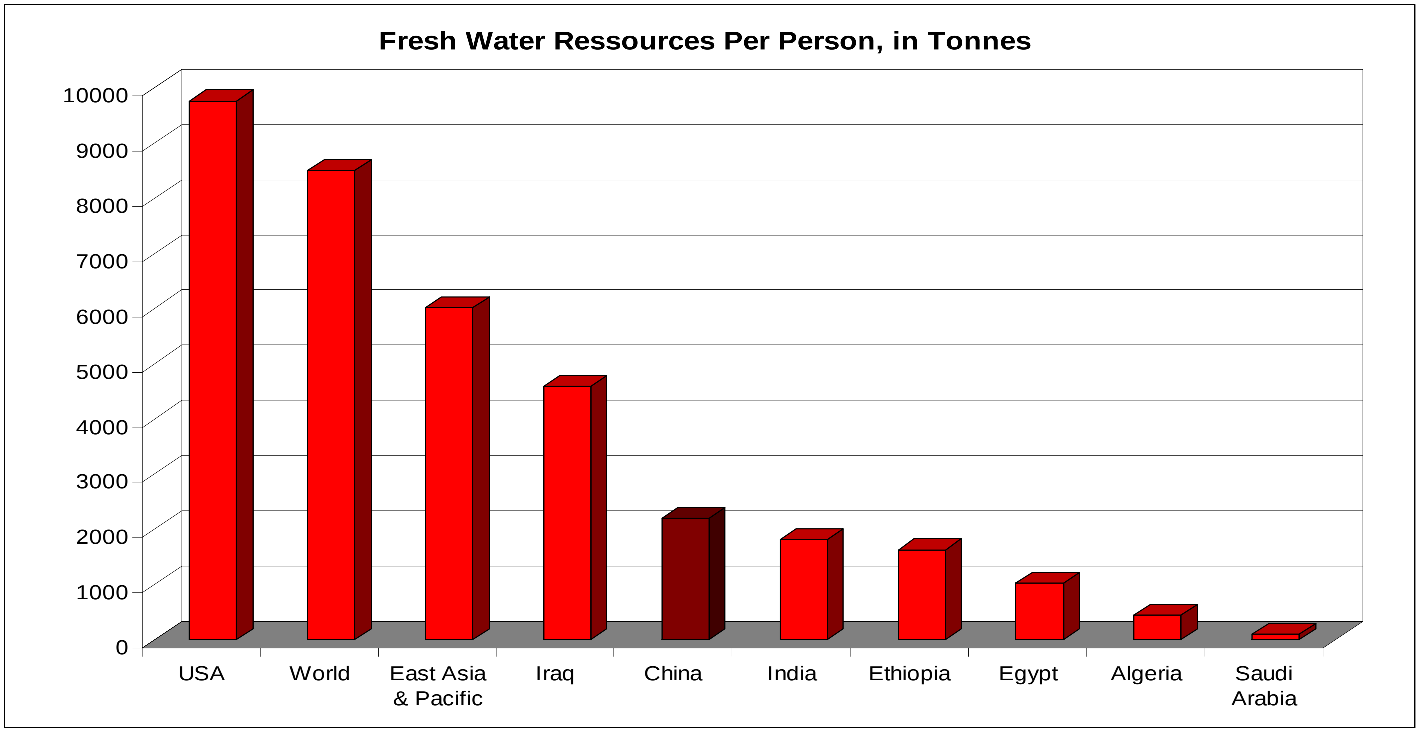


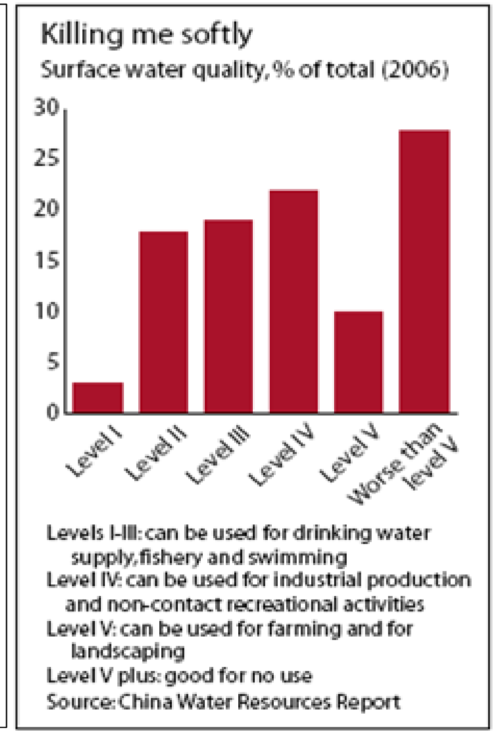


- Up until now, and mostly for security reasons, China has insisted on being agriculturally self-sufficient. But this strategy is starting to hit some constraints, whether because of growing demand for protein (as incomes grow), water scarcity, or simply the fact that with 22% of the world's population and 6% of the world's arable land, the odds are not in China becoming an agricultural super-power.
- China has already taken the decision to import soybeans (triggering a shift higher in prices). Next on the line maybe corn (where the surpluses in Chinese production are dwindling fast) and wheat…

Source: MW GaveKal / GaveKal Research

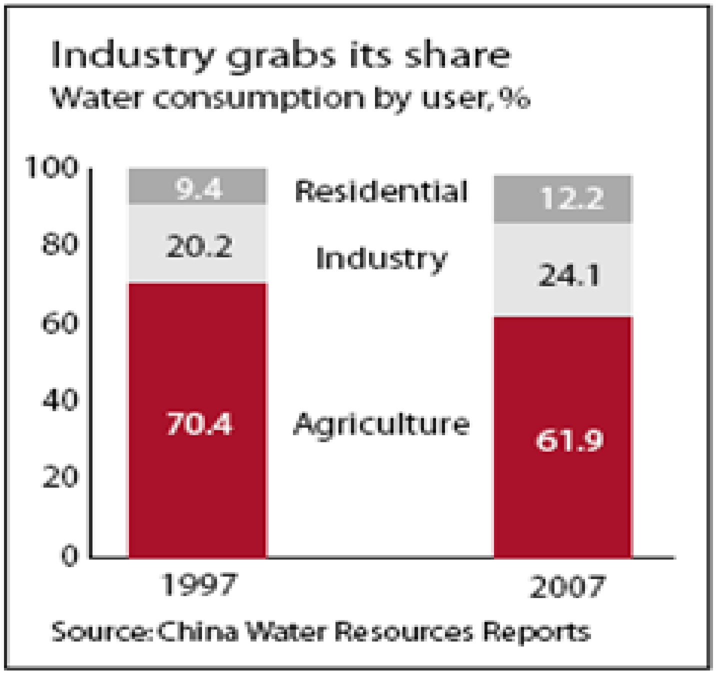
The Biggest Constraint to China's Growth is Water

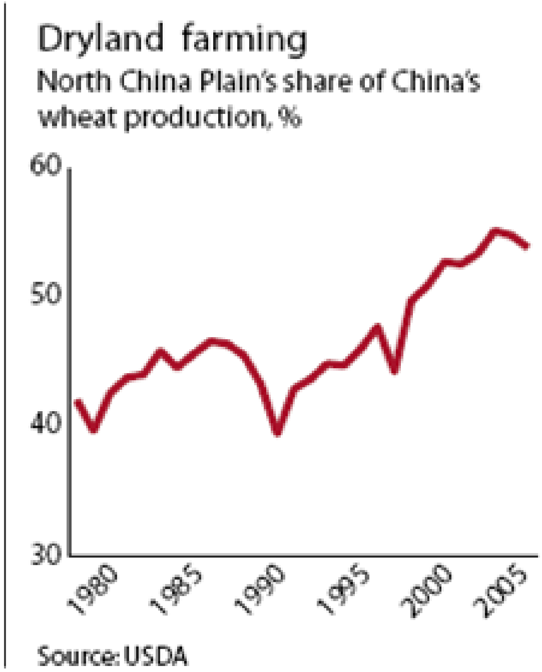




- On a per capita basis, China is basically now at the same level as India in terms of water availability. Northern (industrial) China is even worse with a per capita availability closer to Egypt. Worse yet, the little that China does have is highly polluted.
- More often not, the riots one reads about in the countryside are linked to issues of water rights/pollution. Undeniably, water availability is a significant challenge for China.

China Needs to Start Importing More Cereals & Meat

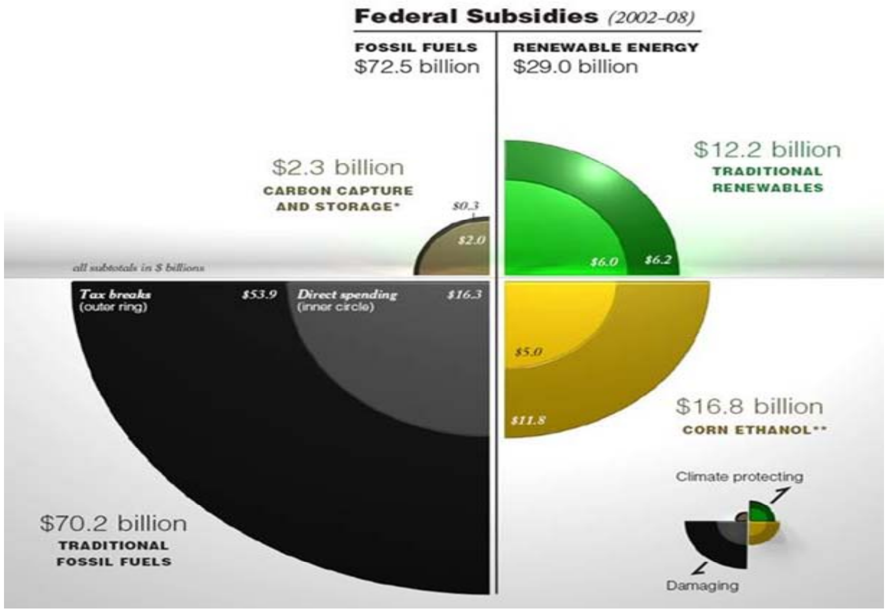




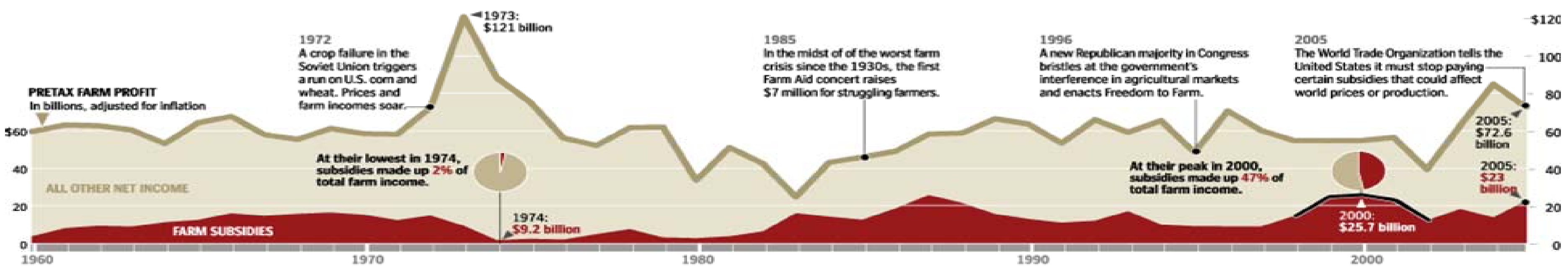
- To this day, more than half of China's water is used by farmers. And this for two reasons: firstly farmers do not get charged a market price (or any price at all!) for water and the water is thus wasted. Secondly, China grows wheat and other cereals in areas where, if water had to purchased, it would not be economical to do so (i.e.: North East).
- So far, China has dealt with the challenge in the old fashion way: throwing money and labour at the problem and creating canals to bring water from the South.
- However, as 'national security' concerns dissipate, could this change? This would be great news for the environment.

Source: MW GaveKal / China Water Resources Reports / USDA / Dragonomics

Another Possible Positive: A Grand Bargain Between the US & China?



- The US is undeniably the 'Saudi Arabia' of food. So much so that a few years back, the US decided to transform food into energy.
- This decision triggered a spike in corn prices and other related foodstuffs (feeds, meats etc…) and has helped maintain prices artificially high. Meanwhile, producing energy from food is very costly to the US government.
- With farm income back to all time highs, and the government looking of ways to cut spending, couldn't a deal be struck where China accepts a stronger RMB revaluation and the US accepts to do what it can to lower food prices?
- Such a turn of event would be very bullish for the world as it would entail a lot less capital mis-allocation.



NOTE: Excludes crop insurance premium subsidies, which would bring the 2005 total to more than $25 billion.

Source: MW GaveKal / Environmental Law Institute / The Washington Post

2) While Sales Growth Will be Strong, What About Earnings

The Challenge of the Investor: EM Growth vs DM Value

- The choice between emerging and developed markets is increasingly taking the form of the age old investor dilemma between ‘growth’ and ‘value’. Emerging markets are now where the ‘growth’ can be relied on but, unlike the past decade, this ‘growth’ now comes at a price. But aside from the price of this growth, another key concern for investors could start to be whether the emerging markets’ top-line growth ends up flowing to the bottom line. Indeed, as we never tire of pointing out, investing in emerging markets comes with its own set of challenges, including:

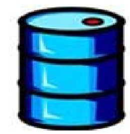
1. **Far greater policy risk.** In the Western world, policy typically operates within a time-tested framework and is usually the result of a long consensual process. Not so in most emerging markets where policy has the ability to surprise in scope, reach and predictability.
2. **Far greater individual company risk.** In emerging markets today, companies typically have a much shorter track record than Western companies. Companies also tend to be far less institutionalized (independent boards, powerful CFOs, management training programs, etc…) than their Western counterparts. Which means that individual company risk is typically higher; a reality which may help explain why historically, EM equities have traded at a discount to DM equities in spite of their economy’s overall stronger growth profile.

- However, at this juncture, for us, the greatest question **remains where the visibility of earnings will prove to be the strongest?** Indeed, assuming that the asset reflation trade is getting ‘long in the tooth’, the question for investors today should be where one is most likely to find sustain earnings growth. And the answers to that question are simply not obvious. Maybe one way to find out is to put one’s self in the shoes of local businessmen and empathize with the challenges that they may be confronting today.

Source: MW GaveKal

Are Investors Overlooking Growing Uncertainties in Emerging Markets

Final sales?



Material costs?

Labor costs?

Exchange rates?

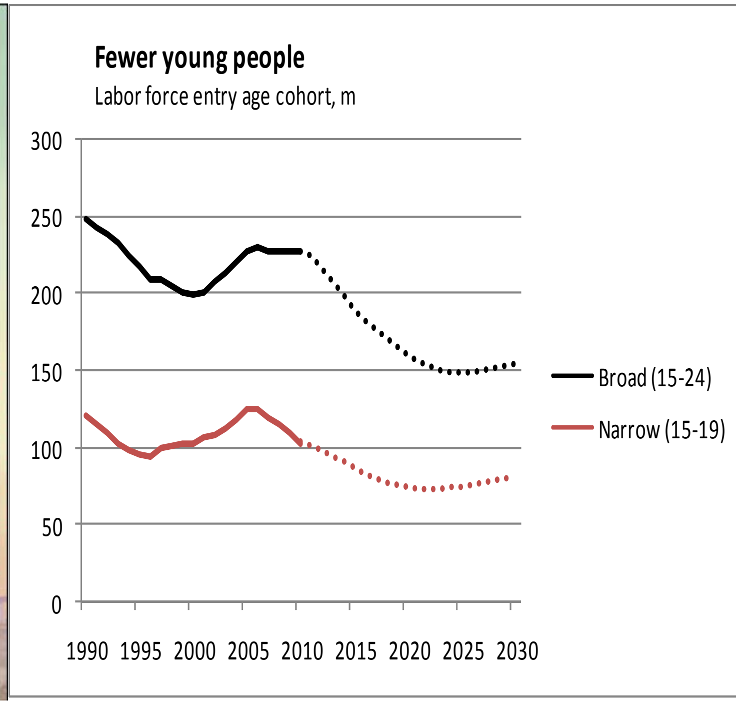
Costs & availability of capital?

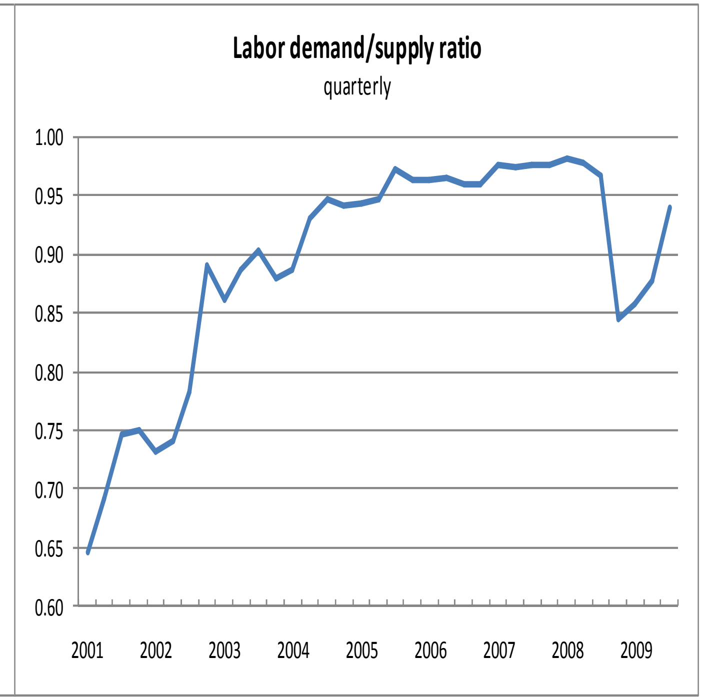
Taxes and regulations?

Visibility on Emerging Market sales is undeniably strong.
But what about the visibility on costs?

Source: MW GaveKal

Labour Costs Are on the Rise in EM, Probably Structurally

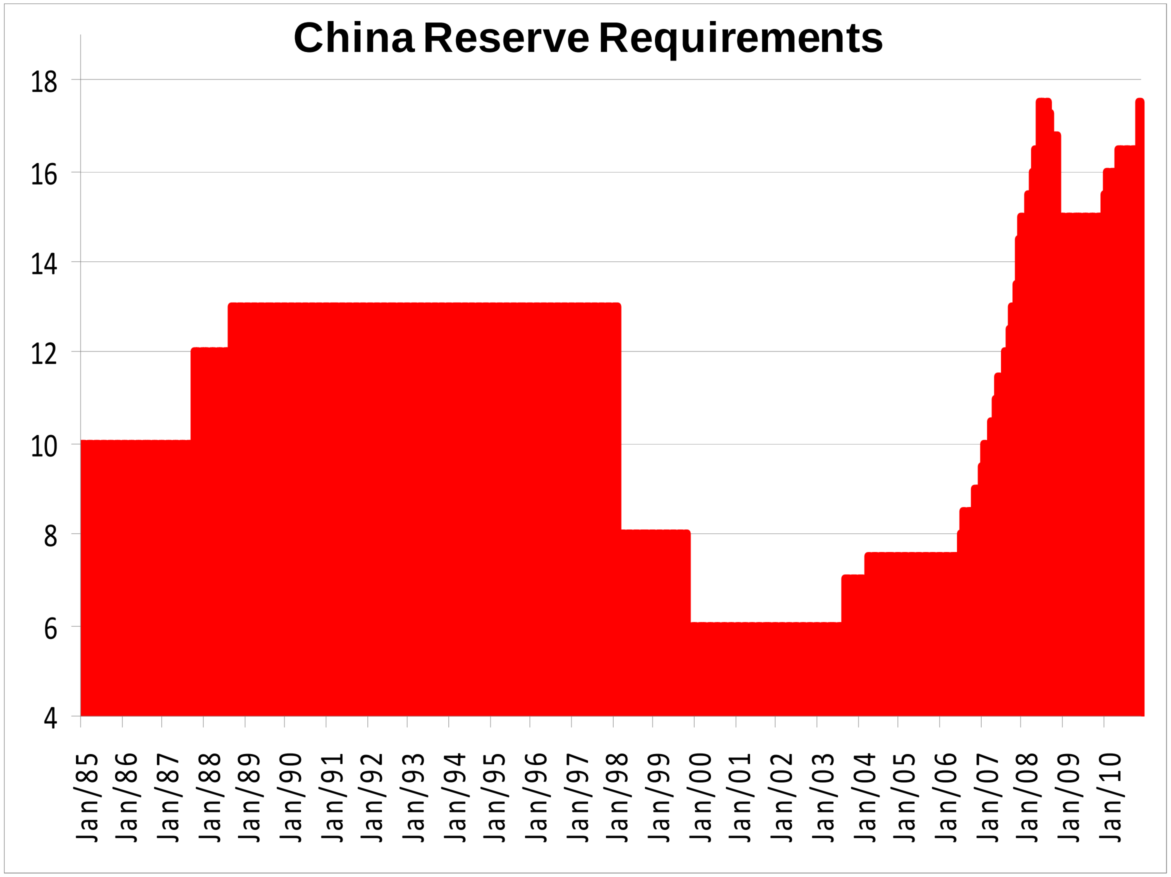




- We have argued at length that one of the key global developments was the end of ever-falling labor prices in China. This shift, which happens to coincide with the fact that the Chinese labor force is no longer expanding is a genuine paradigm shift.
- In the next decade, the number of 15-24 year old workers (the age group most willing to move to get a better-paying job) entering the workforce will shrink by one third. No major economy has ever witnessed such a precipitous drop-off in working youth in peace-time. We are stepping into unchartered territory.

Source: MW GaveKal / The Economist / GaveKal Research

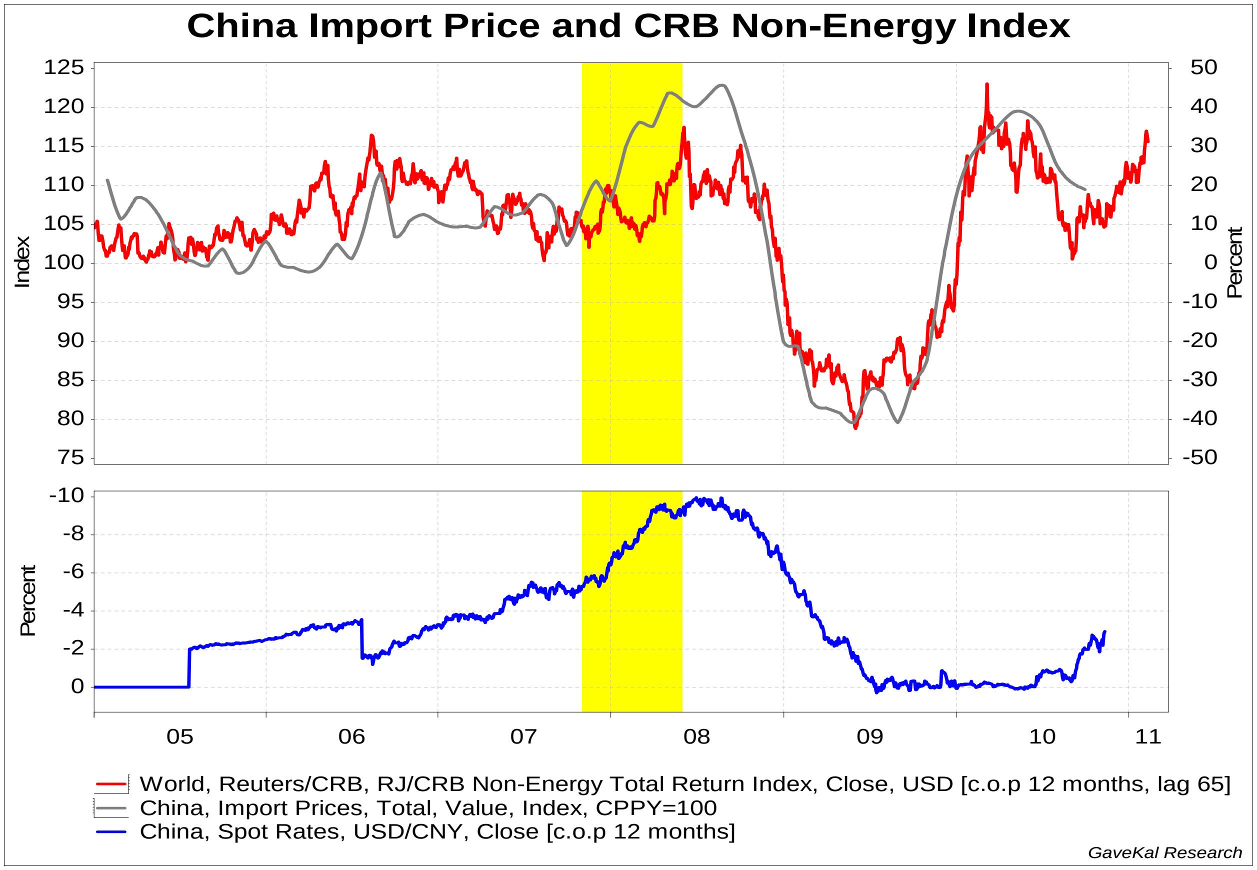
Capital Cost is Rising and Availability Shrinking



- With two increases in the past month, Chinese reserve requirements are back to the all time highs that prevailed in the pre-Olympics inflationary wave.
- And this spike in inflation is not just a China problem: most emerging markets are either raising interest rates or raising reserve requirements .
- Undeniably, the cost of capital in emerging markets is more likely to creep up than in developed markets.

Source: MW GaveKal / GaveKal Research

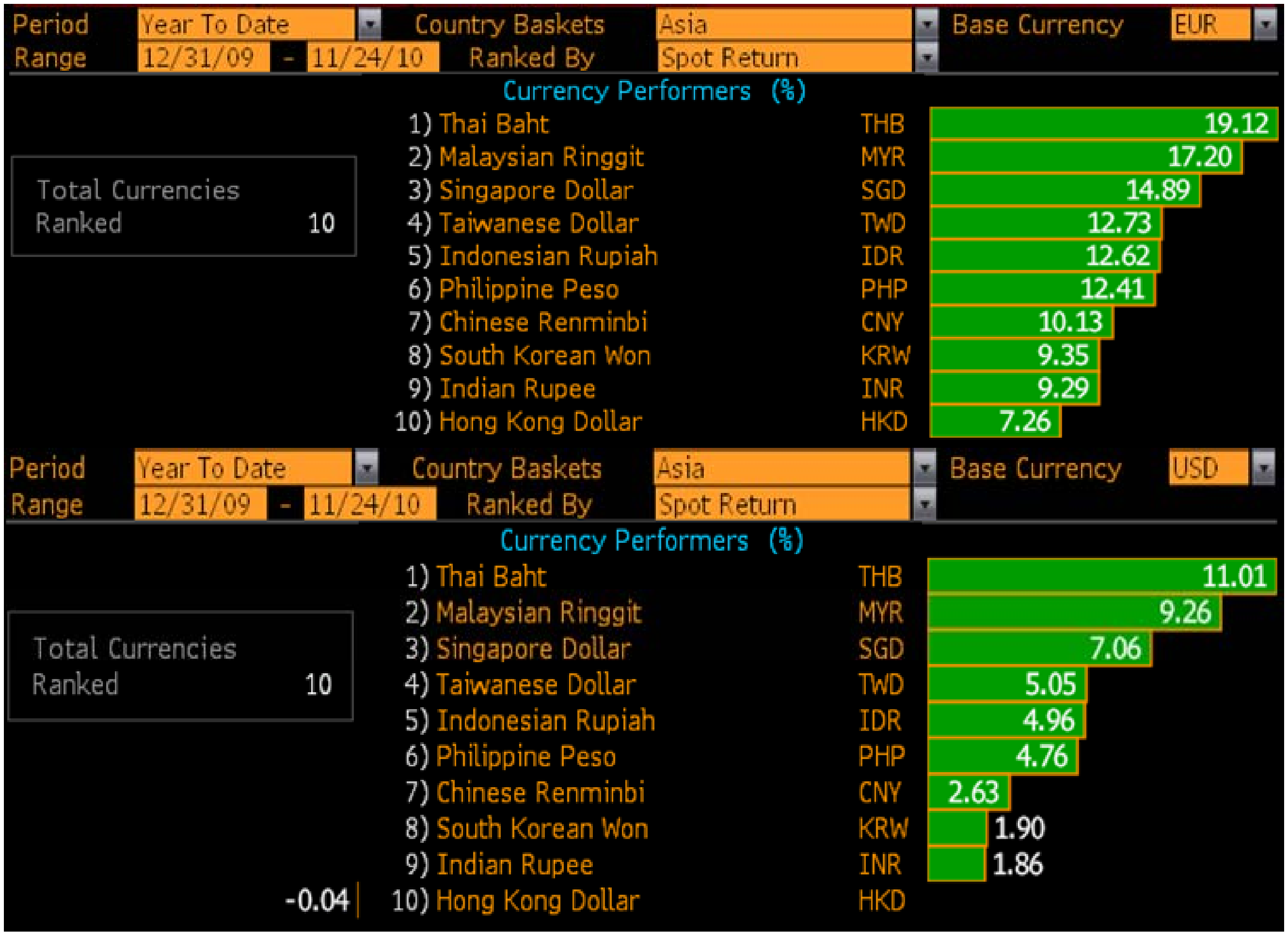
EM Also Dealing With Inflationary Problems Through Higher Currencies



- Chinese inflation is undeniably a growing concern for the leadership.
- One easy way, which was tried in the past, of dealing with inflation is by allowing the RMB to revalue.
- In recent months, the RMB has been on a 6% per annum revaluation trend. We would expect this to continue or even pick-up a little speed.
- How will this impact Chinese producers? Those that can't take it will disappear…

Source: MW GaveKal / GaveKal Research

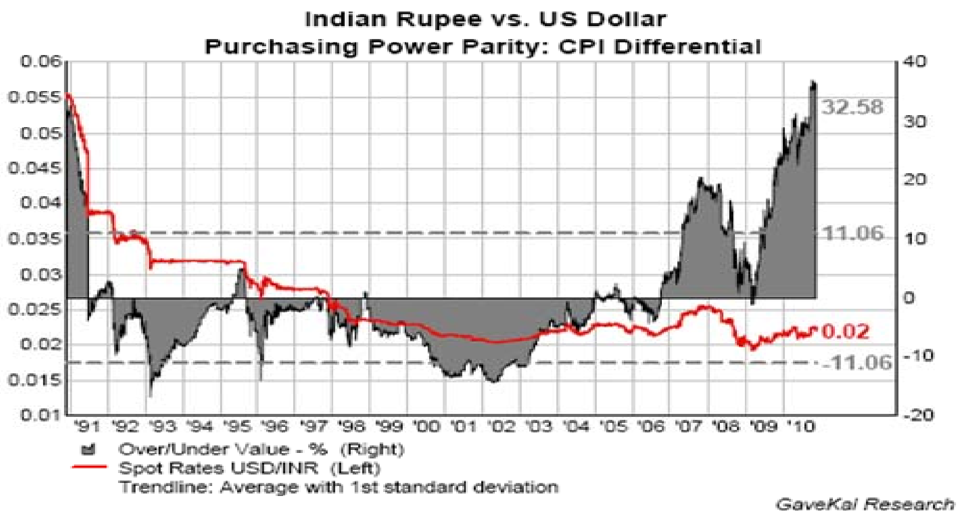
To Some Extent This is Already Taking Place

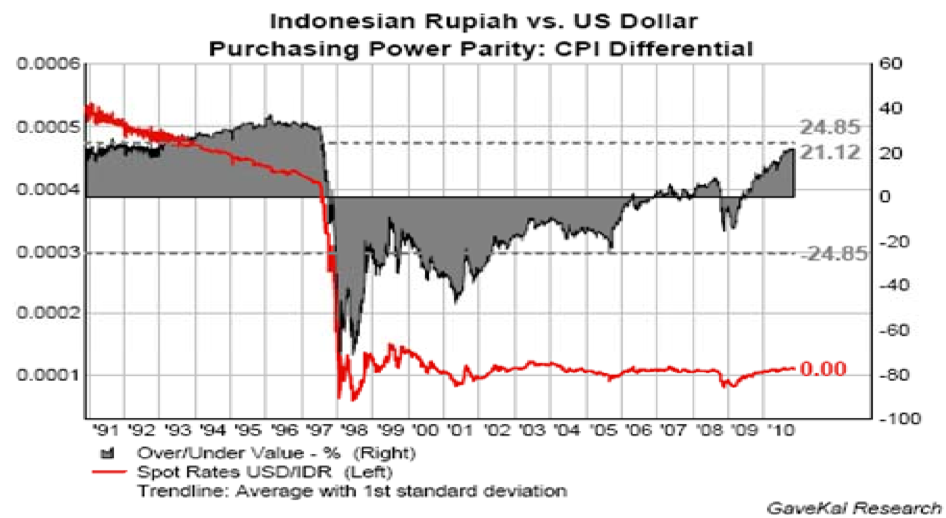


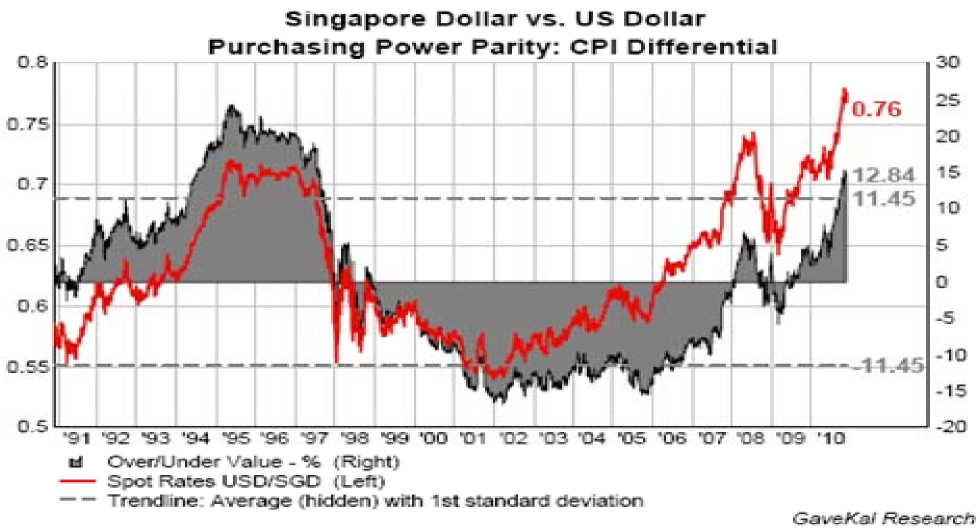
- This is the first time in our careers that we see **Asian currencies rise against the US$ and the Euro at the same time.**
- This is not a surprise; in fact, it makes perfect sense given that this is the first cycle in which Asian central banks are tightening before the Fed and the ECB.
- We have been, and remain, bullish on Asian currencies. A continued adjustment seems likely in light of Asia's growing inflationary pressures.

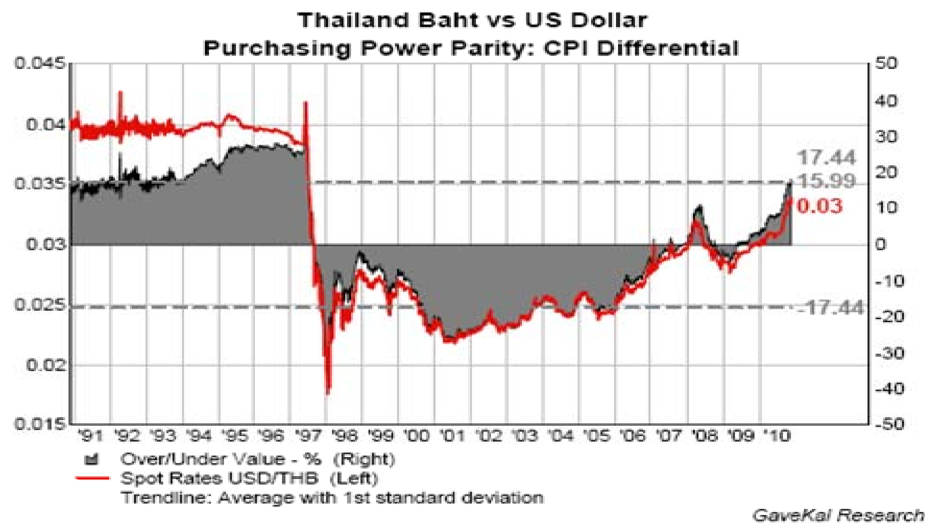
Source: MW GaveKal / Bloomberg

But Higher Currencies Will Hurt Some As Valuations No Longer Cheap



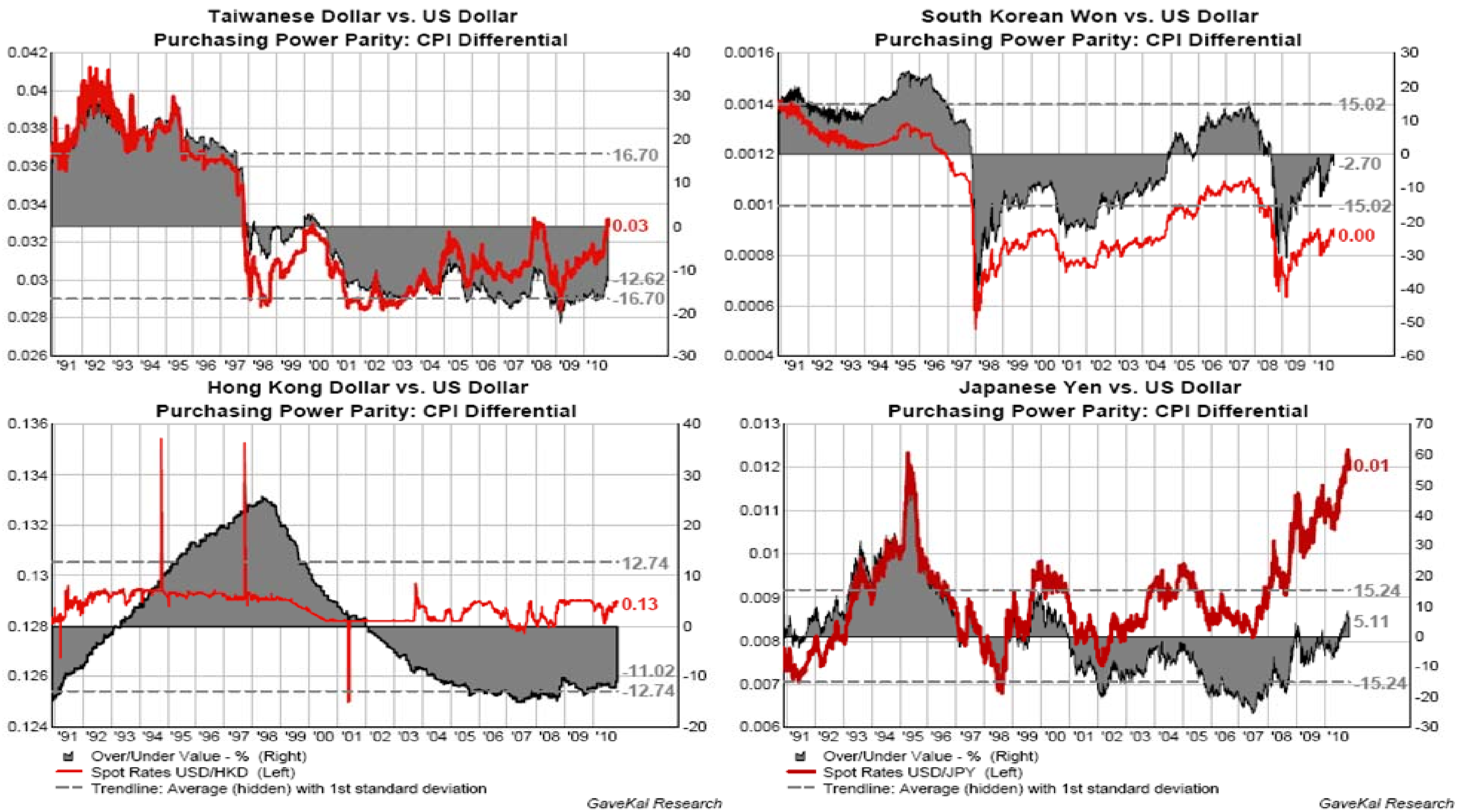






Source: MW GaveKal / GaveKal Research

Asian Countries that Seem to Have Most Room for Revaluation



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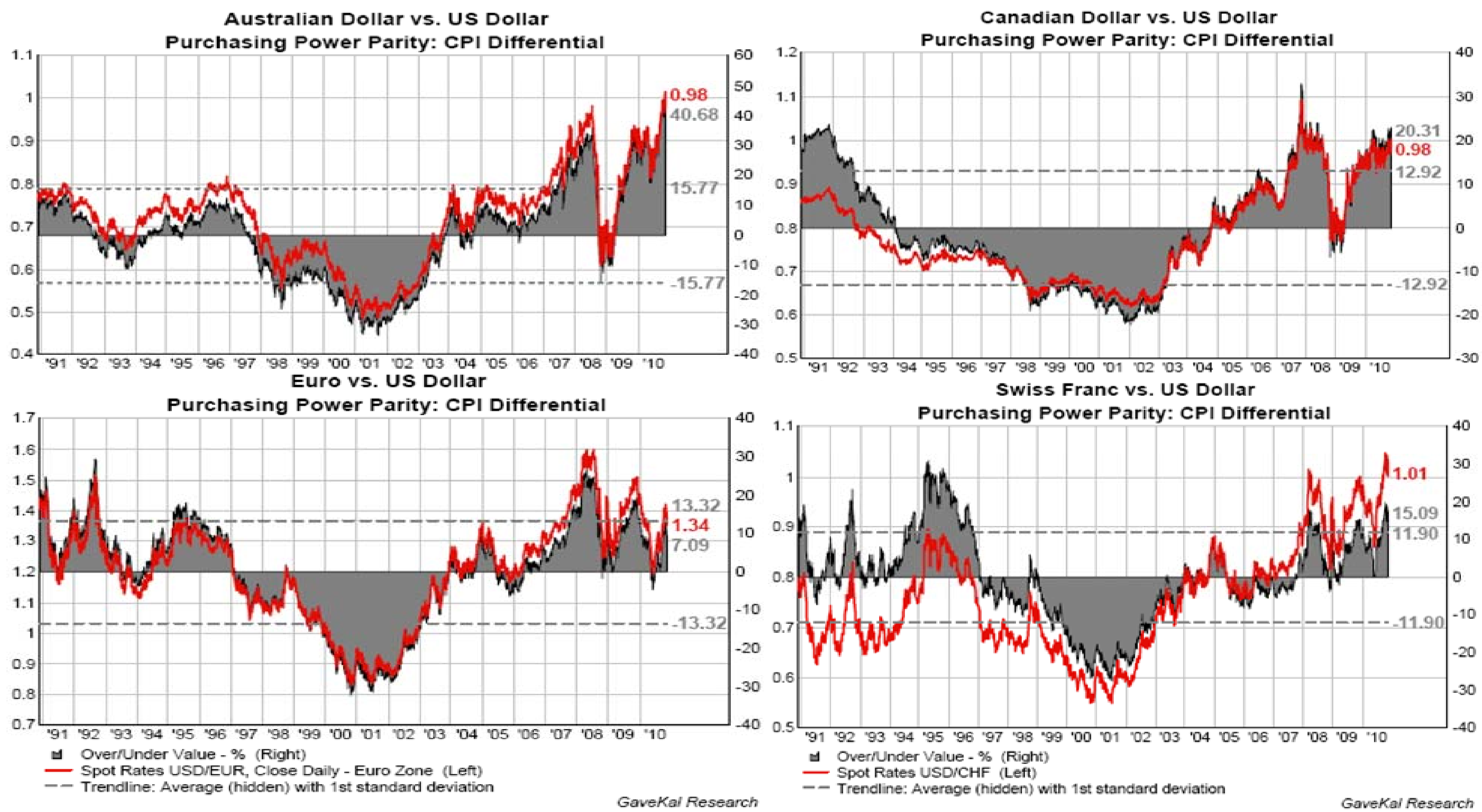
All The More So Since Other DM Currencies Are Also Expensive



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