

Emerging Markets – The only place to be

- Emerging markets are attracting more money from initial public offerings than industrialized nations for the first time.
- Investors are paying the most for profits in developing nations since April 2000, with the 767 companies in the MSCI Emerging Markets Index valued at an average 24.2 times earnings, data compiled by Bloomberg show.
- “Emerging markets are really the only place to be ... The developed markets are really going to lag from a growth and an earnings standpoint” Jeffrey Palma, head of global-equity strategy for Zurich-based UBS AG.

Developed world ... sounds like we're all done. It's been a good run, now pack up your bags and get the heck outta here. The picture of a massive growth phase in emerging markets is hard to argue. The headlines above are a few we've pulled out of the paper this week. There is no shortage of cheerleading for this theme. Let us be clear, we too understand the importance of these emerging countries and their impacts on global growth. But history is riddled with examples of emerging market problems. Even if this time is different, famous last words, the growth will not be without bumps. The really good news that investors of the developed world seem to be depending on has little room for error. We wholeheartedly disagree with the quote above from Mr. Palma that emerging markets are really the only place to be. Very rarely do the bulls on this theme discuss valuations or domestic competition driving margins down for these supposed sure bets.

This week we've included an article with STRATFOR's take on recent developments in Chinese banking, we think you'll find interesting. STRATFOR is a well respected geopolitical and economic intelligence firm.

Liu Mingkang, head of the China Banking Regulatory Commission (CBRC), said in an interview Jan. 20 that several Chinese banks had been asked to restrain their lending after proving to have inadequate capital reserves. Chinese media reports claimed that new bank loans so far in January have risen to as high as 1 and 1.5 trillion yuan (\$146-\$220 billion) — approaching or equaling the massive hike in January 2009. As a result, several major Chinese commercial banks (whose names were not given) were given oral commands to stop new lending for the rest of the month.

While the regulators will strive to control credit flows, the broader Chinese imperative to maintain growth at any cost contradicts the ability to preserve loan quality and allocate capital efficiently. Under the guidance of the central government, bank lending — the dominant form of financing in China — has skyrocketed in the past year

to spur growth, fend off the effects of slower global trade and thereby maintain social order. Amid the loan boom, Chinese authorities have at times sought to restrain banks, fearing a massive buildup of bad loans. In February, April, July and October 2009, Beijing restrained the banks, only to see lending spike again in March, June and September 2009 — and now again in January 2010. Essentially, Beijing was caught in a cycle of speeding up and slowing down credit expansion. With each deceleration, China's loan-dependent businesses, mostly state-owned and state-controlled, cry out in pain, resulting in another acceleration to make sure they do not grind to a halt.

2010 is expected to be another year of high lending, with Beijing projecting 7.5 trillion yuan (\$1 trillion) in new loans — a smaller sum than the 9.6 trillion yuan (\$1.4 trillion) lent in 2009, but indicative of a glut of credit consumption. In order to achieve even a mild reduction in lending in 2010 (not to mention the roughly 28 percent reduction target), the Chinese authorities know they will have to take some serious actions to restrict the banks. Hence, the demands for banks to increase their capital bases beginning in late 2009, and the raising of reserve ratio requirements on Jan. 12, forced banks to set more cash aside that would otherwise be lent out. The Jan. 20 demand that certain commercial banks stop lending for the rest of the month is another such move.

The problem for China is that the entire economy depends on extremely loose lending policies, and when credit slows, companies in the critical manufacturing and trade sectors get squeezed. A great many Chinese companies rely on external consumers for their profits, but while exports showed growth for the first time in December, they face the usually slow months of January and February; only when spring comes around will it really be clear whether global demand has recovered sufficiently to support China's exporters. Thus, exports are no refuge yet, and since Beijing has no intention of knocking the legs out of growth, it will continue shoving credit into the system.

Later in the week China announced Inflation accelerated to a more-than-forecast 1.9 percent in December and gross domestic product climbed 10.7 percent. Global central bankers for the past 18 months have all been implementing massive monetary and fiscal stimulus. The fact that they have all been moving together with their policy was a strong force. We would guess that over the next 18 months they will be moving in different directions and at different speeds. This will make for a more challenging environment. Some like China will be trying to reign in their stimulus and slow down their growth. While others like the US, UK, and parts of Europe will be still trying to stabilize their banking systems.