EMERGING MARKETS ILLUSTRATED

MIRAE ASSET
Building on principles

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*"In this country, you gotta make the money first. Then when you get the money, you get the power. Then when you get the power, then you get the women." –**Al Pacino**, Scarface*

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Observations

Following the Money

Last week EM equity funds saw their sixth consecutive week of net inflow and flow of funds continue to be a trend worth watching. Year to date, according to **EPFR Global**, emerging market equity funds have received a net $23 bn in inflows. August alone saw $9bn net inflows. This compares well with 2011 when global investors dumped the EM equity class to the tune of $34 bn.

Some clients are taking the view that since the US has outperformed strongly since the beginning of the GFC and now just a hair away from record highs, it is time for a breather. In the last couple of days, the **Hong Kong Monetary Authority** stepped in twice to intervene in the currency market for the first time in 3 years. A stronger HKD is the natural result as Asia feels the QE3 monetary tsunami being unleashed by Ben and friends.

Risk appetite is increasing as evidenced by the rising US 10-year bond yield, which is moving up nicely. Just since early September, the Hang Seng Index has jumped 14% and India has risen 8%. Looking at where we stand year-to-date, the HSI is up 18% and India even more, at 21% vs. the S&P 500, which is up 12%. Emerging markets are just now starting to outperform the US and I think this trend will run a while before it dies.

It Sucks to Be You

Jerome Kerviel, **SocGen**'s rogue trader who in 2008 lost the bank a record 4.9 bn euro ($6.7 bn USD at the time) had his appeal rejected this week. The son of a hairdresser and a blacksmith who grew up in a small town in Brittany, Kerviel (like **Nick Leeson**) got into trouble trading stock index futures in amounts almost beyond comprehension. According to SocGen, he had bets out in the market at one time totaling 50 bn euro – way more than the bank's total market cap. And he did this alone with no one aware of his trades, so says the bank. Incredibly, SocGen won its case with that line and Kerviel was sentenced to 5 years in prison, banned for life from working in banking, plus he HAS TO PAY 4.9 BN EURO back to the bank. Only in France does this make sense. Now working as a computer security consultant in Paris, it is unclear when he has to go to jail. Either way, I figure if he is diligent and able to save 25,000 euro a year on his now reduced income, Kerviel is looking at paying off his debt to the bank in just 196,000 years. Will Soc-Gen be around then? What about France?

Master of the super-pissed-off facial expression, I noticed a striking resemblance between Jerome Kerviel and **Ewan McGregor** who played Leeson in the 1999 film, "*Rogue Trader*."

Life

Art

Americana

I went for a haircut the other day, which is the only time I get to read "*People Magazine*" and other lowbrow crap that I won't allow in my house. As I was flipping through this trash at speed wondering who reads this stuff, the 60-something female hairstylist commented while trimming my golden locks,

"You have nice ears."

"Yes," I replied. "They are my best feature."

Sigh, it is very easy living in America. Bloomberg recently ranked the "*Top Ten Best Cities to Live in the US*," weighting urban centers on income levels, crime, air quality, restaurants, museums and libraries. **San Francisco** topped the list and, I was pleased to note our new home, **Seattle**, ranked a close second.

But things aren't perfect. Another survey that came to light today is the more interesting, "*Top 20 Airports for TSA Theft*." The TSA is the **Transportation Security Administration** (or, *Thugs that Steal Anything*) an organization of ne'er-do-wells formed right after the 9-11 terrorist attacks on New York. While nobody can argue with the premise behind better security and the benefits of greater safety for the long-suffering travelling public, the TSA has regularly found itself in countless embarrassing cases of gross misconduct. Anyone who has had the misfortune to travel by air in the United States in the last 10 years has encountered these people, usually overfed and undereducated, who insist on strip searching little old ladies from Iowa on the way to visit their grandkids. Not only are the gestapo frisking sessions unpleasant but apparently, a large number of TSA's finest like to steal your stuff as well.

Information obtained by *ABC News* under the Freedom of Information Act amply demonstrates the problem. The worst airport for luggage theft by the TSA – the people who are there to protect your security – is **Miami International** where 29 TSA employees have been fired over the last ten years for purloining traveler belongings. Miami is only the 12^{th} busiest airport in the country and to top this list is not good. Talk about Miami vice. Number two is **JFK** and number three is **LAX**. No surprises there, I guess.

ABC News also conducted its own intriguing investigation where they left 10 iPads at 10 different airport security checkpoints. Happily, nine were returned but the last iPad was tracked for 30 miles as it left the airport and went straight to the house of one Andy Ramirez, a TSA employee. He first denied having it, then he thought blaming his wife would work and finally he just coughed it up. With all the publicity, Mr. Ramirez was eventually fired.

Another "Top Ten" survey out today lists the "*Top Ten US Cities with the Cleanest Air*." Most of the cities on the list are in Florida, which enjoys sparkling air washing over it daily from the Atlantic and the Gulf of Mexico. Again, Seattle ranked well, at number 8. After six years of hacking up pieces of lung in Hong Kong, the gift of perpetually clean air is something we no longer take for granted. Along with a clean environment also comes the benefit of clean smelling water, as well. I am reminded that the Chinese characters, "Hong Kong" mean "*Fragrant Harbor*," proving that despite reports to the contrary, the Chinese do indeed have a sense of humor.

Research

"I looked at a Ford Karmann Ghia

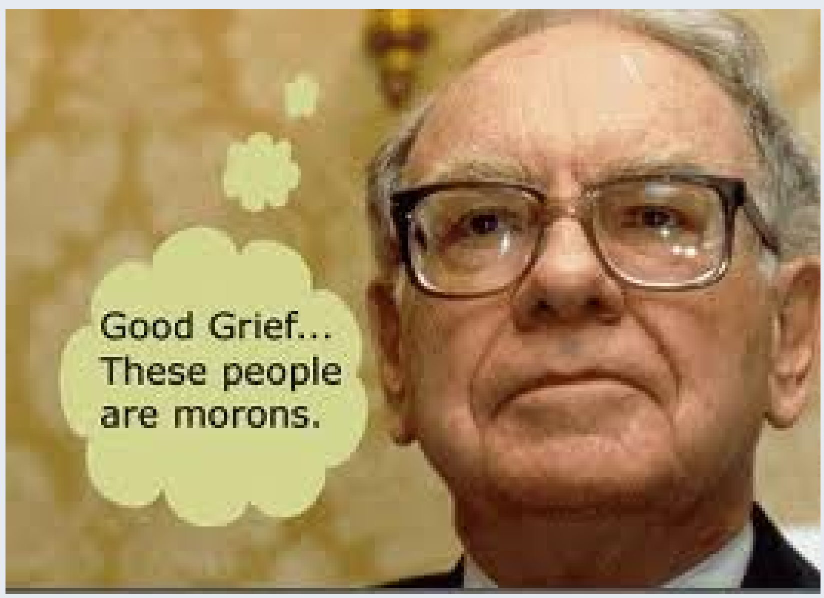
Then checked out the cars from Korea

Well-built and quite nice

And a quarter the price

I ended up buying a Kia" – **Graeme King**

We have a cartload of research to overturn this week and some interesting calls are found inside. I drove my younger daughter to school today listening to the radio as per her demands – she's not quite four and already a big fan of The Clash – and I noticed there are definitely more and more Hyundais and Kias on the road than just a few years ago. Not only that, most drivers don't seem to be embarrassed driving them. The designs have improved and the features on offer at the price point are attractive.



Analyst and tough guy, **Yoon-ki Kim**, initiates on the Korean auto sector with an Overweight rating ("Ample Growth Potential"). Despite continued worries of a global slowdown (how long have we been talking about that?), Yoon-ki believes the global auto market will expand in excess of 5% for the foreseeable future, slightly above consensus. Both **Hyundai Motor (005380 KS)** and **Kia (000270 KS)** sold off heavily earlier this week on rumors of poor 3Q operating margins yet, it turns out the rumors had no basis in fact. HMC just announced very strong 3Q results, reporting profit that exceeded analyst estimates. For comparison, **Volkswagen** reported the same day but saw operating profit plunge 19% over the same period. With the summer labor strikes behind them, HMC is set to beat its full-year sales forecast, helped by strong demand in China. I also note, despite being captives of the worst equity market in Asia, Chinese auto stocks are in the early stages of a rally (**SAIC, Brilliance, Changan**, etc). Is it time to don the **Warren Buffett** super cape and "*Be greedy when others are fearful*"? Let's open the doors and take a closer look.

HMC and Kia in the first half of this year posted OP margins of 11.4% and 9.6% respectively – higher than any carmaker bar BMW. Some of this is due to successful platform integration with a reduction from 18 disparate platforms to just 6, as well as enjoying industry-low incentive levels, thanks to product quality improvement. In fact, in last year's **JD Power Survey**, Hyundai tied with Honda for second place for quality. This year the Kia Soul won top awards for quality for the compact, multi-purpose vehicle segment.

Not Your Dad's Hyundai

The product we know as "a car" is evolving rapidly, aided by technological advances in fuel economy and some new, whiz-bang features, such as **SCC** (Smart Cruise Control), **LKAS** (Land Keeping assistance) and **HUD** (Heads Up Display). Aside from a button on the dash that when pressed releases hundreds of carpet tacks behind you for tailgaters to navigate, one feature I'd like to see added would be the **COS** (Cone of Silence), a sophisticated device useful for suppressing annoying passengers.

You can't buy a new car today without airbags, nor would you want to, but it wasn't so long ago that this was a "space age technology." On the fuel economy side, the US is mandating 54.5 mpg efficiency by 2025, and cars have seen the greatest improvement in mileage since the 1990s. Internet capability along with greater smartphone compatibility and other features such as "infotainment" (yuck, that's an ugly word) are areas that are capturing consumer imagination. The goal in driving is to make the experience safer, more convenient and more entertaining. Yoon-ki believes all this innovation will encourage more frequent upgrading among consumers.

The HMC and Kia story mainly boils down to rising OP profit per unit and steady global market share gains. Both companies are exposed to BRIC markets, particularly **Brazil** and **Russia** and they also have a growing presence in the US and Europe. While in a coma now, the European auto market will bounce back as millions of newly impoverished Europeans set their sights on lower priced attractive alternatives to previous favorites BMW and Mercedes. HMC and Kia will continue to benefit.

China is now the world's largest car market with 19.2 mn units forecast sold this year. The problems between China and **Japan** regarding a few rocks off the coast of **Taiwan** have severely dented sales of Japanese cars in the country. Even if one didn't have a strong opinion on the subject, the fact that a mob in Xian dragged a man out of his **Toyota** and beat him to a pulp does give potential Toyota buyers pause. Indeed, Toyota and Honda JV partner, **Guangzhou Auto** reported sales dropping in September by a third. **Dongfeng Auto**, the JV partner of **Nissan** (the word "*Nissan*" in Japanese, by the way, means "*Made in Japan,*" not very helpful in the current environment), also saw sales plunge 30% last month. If there is one thing uniting Chinese and Koreans above all else, it is their strong negative feelings toward Japan. However, whether these regular cycles of nationalist passion in China result in further market share gains by HMC and Kia at the expense of the Japanese still remains to be seen.

Valuations are certainly attractive; both HMC and Kia are trading at 6X PER, the bottom of the industry range despite superior growth and the highest OP margins and ROE among the major players. Of the two, Yoon-ki prefers HMC over Kia due to its stronger R&D support from the parent company, higher OP margins and greater brand equity.

The charts don't look great, however. Kia, in particular, has driven off a cliff with the shares down 21% in two months.

Another play on the increasing global demand for Korean cars is **Hyundai Hysco (010520 KS)**, which analyst **Haesoon Kwon** initiates on here with a Buy rating. Although the company has a weird motto: "*To bring safety and happiness to people within steel*," Hysco has brought happiness to shareholders this year with a stock that is up 33%. The global steel sector overall is slumping with overcapacity and slack demand, especially in China, keeping a lid on things. The Korean steel sector P/B discount to the Kospi of 20% remains at the 10-year average; valuations are not exciting. Hysco is more enticing due to higher earnings visibility via strong car sales by its captive customers (and major shareholders), HMC and Kia, which source 60% of their automotive steel needs from the company. The company also enjoys higher ROE (18%) than its peers.

With new factories opening, Haesoon forecasts sales of high margin automotive Cold Rolled Coil to rise from the current level of 58% to 65% by next year. Overseas plants in China (now operational), Brazil and Turkey will be ramping up as well.

Hysco is a beneficiary of Won depreciation with exports accounting for 36% of sales and imports only 10% of costs. But that Won is not depreciating, in fact it is up 7% ytd vs. the US dollar. QE3 and Uncle Ben warning other countries not to get in the way of a weaker dollar means this is a rising threat to the company.

“Their standard is to make us poor.” – **Mario Cuomo**, former governor of New York after an S&P rating downgrade of his state

But do you want to buy a steel company right now? This week **Posco (005490 KS)**, the fourth largest steel producer globally, released disappointing Q3 results: operating profit dropped 18% and the company slashed its full year forecasts more than 10%. Monday this week, **Standard and Poor’s** downgraded Posco’s rating by one notch to BBB+. Two days later, **Moody’s** followed up with their downgrade of Posco’s foreign currency bond rating to Baa1 from A3. The rating agency cited “*high debt levels, the persistent sluggishness in the regional steel industry*” as two of the reasons for the downgrade.

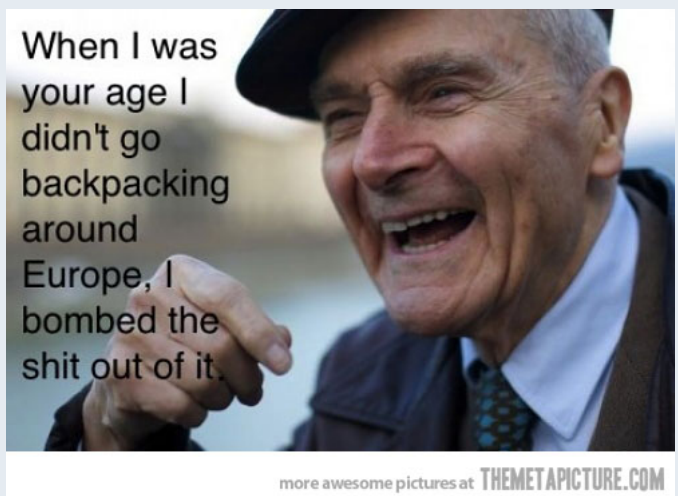
"You seem to have the qualifications we're looking for in an accountant"

My view: Buy HMC now with the stock off 10% from recent highs.

Sinorama

There are many who believe that China is set on making the Rmb become a global reserve currency and that an opening of the capital account, where the Rmb is tradable without restriction, is imminent. I have a problem with this view. Let's start with an open capital account. There's that word that Beijing hates: "open." This implies a free exchange with no political interference. How often have we seen that happen in China? Whether it is business, sports or even entertainment, the specter of big brother hovering above all actors with a giant skull-smashing hammer never leaves.

The Renminbi, or "People's Currency" has been around since 1948, just before the founding of the PRC a year later. Currently, China is using the fifth series of the notes which were released starting in 1999. I find it interesting that aside from greater anti-counterfeiting measures embedded in the design, this series is the first to have ALL notes using the portrait of Mao. Previously, various party officials and fat-faced peasants on tractors were the socialist motif of choice.



Until 1995 China didn't even have an open current account and the economy worked on a two-tier currency system: Rmb for locals and "*Foreign Exchange Certificates*" for foreign devils. Any goods of value, such as televisions and other appliances were almost all imported and could only be purchased with "*FEC*" at the hilariously misnamed "*Friendship Stores*." This created huge domestic demand for FEC and I remember well traveling around China then and being ceaselessly pestered day and night outside hotels, restaurants, guesthouses and even public toilets with the words, "*HELLO! Change money*!" Whether buying a train ticket, a meal in a restaurant, or even a dusty apple by the roadside, you, the foreigner had to pay in FEC, which due to the mandated exchange rate meant you paid about 8 times more than the locals for the exact same goods and services. When I complained about such abstruse concepts as fairness it was always explained to me in this way, "*You have more money so you should pay more!*" As a penny-pinching backpacker at the time, I have to admit, it rankled.

The highest denomination note in China has been and still remains the 100 yuan bill.

This is true even though today it is only worth US$16. Using cash in any quantity in China means carrying around buckets of the stuff which is one reason, I expect, that well-heeled Chinese men sport "*man bags*," or what Americans politely refer to as "*European satchels*." The low denomination of the currency is to prevent black market dealings and to better track those that ahem, may occur.

Another problem with an open currency is the demand side of the equation – what are people supposed to do with billions, or even trillions of Redbacks? Despite the GFC rocking the capitalist foundations of "the West", with the US dollar you get the world's largest and most liquid market; the US treasury market. What do you get for your 500 man bags stuffed with Rmb? A few "dim sum" bonds. That isn't enough.

Currently, if you are a trader and buying clothes pins in China for export to Pakistan you need US dollars. The Rmb has been open for trading goods since March this year but the trade has been heavily skewed toward imports into China. Chinese are buying stuff with Rmb because they have the currency and non-Chinese have a hard time earning it or getting any in size to be useful.

Patrick Chovanec, a professor at **Tsinghua University** has written an interesting article on the subject of Rmb internationalization (here). In it, he also points out that if the Rmb were to be made fully convertible and the economy completely open to international fund flows – how would China hide its current debt bomb in the banking and property system?

China may have three-odd trillion US dollars in f/x reserves but aside from being a somewhat dull factoid to impress large-breasted women at social functions, these reserves are not useful. China can't "spend" it and most of the pile sits in US treasuries; money they can't get back. Such massive reserves, unprecedented in world history, are a sign of an unhealthy imbalance, much like an obese person suddenly losing 100 kg, not due to exercise and clean living but rather because of a tapeworm.

The Rmb becoming a global reserve currency after China opens its capital account?

My view: Ain't gonna happen.

The Last Page

A crusty old man walks into a bank and says to the teller at the window,

"*I want to open a damn checking account*."

To which the astonished woman replies,

"*I beg your pardon, sir; I must have misunderstood you. What did you say?*"

"*Listen up, damn it. I said I want to open a damn checking account right now!*"

"*I'm very sorry sir, but we do not tolerate that kind of language in this bank*."

So saying, the teller leaves the window and goes over to the bank manager to tell him about her situation. They both return and the manager asks the old geezer,

"*What seems to be the problem here?*"

"*There's no friggin problem, dammit!*" the man says, "*I just won $50 million bucks in the damn lottery and I want to open a damn checking account in this damn bank!*"

"*I see*," says the manager, "*and this damn woman is giving you a hard time?*"

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