EMERGING MARKETS ILLUSTRATED
MIRAE ASSET
Building on principles

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"It never rains on your neighbors without you getting your feet wet." - **Chinese proverb**

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Observations

Donkeys are common on Cyprus and are a symbol of the island's agrarian past – a way of life many Cypriots may be returning to pretty soon (one more blast on Cyprus and then I'll leave it alone). Commentators point out that "tiny" **Cyprus** is "economically insignificant" with the implication being the financial persecution occurring in the remotest corner of the EU is of little concern to us. They are wrong. Cyprus, as I argued last week, may not have much impact on equity markets <u>but it is a game changer as far as what Europe is about and the message it is sending domestically and abroad.</u>

Last week, the EU was happy to raid guaranteed bank deposits no matter the size. This week, after parliament in Cyprus voted down the theft, the bland Orwellian statement which dribbled from the lips of the Eurozone regarding the new "deal" for Cyprus should make all European depositors shudder:

"There will be a safeguard [on] all deposits below €100,000 in accordance with EU principles."

Principles, we must note, which were conspicuously absent just a few days ago.

The Cypriot government, which has shut the banks, has also passed laws shutting off any possibility of capital escaping and the matanza now begins. How does one explain

monetary union with selective capital controls? Anyone who believes such controls will only last for a few days are listening to what politicians are saying rather than watching what they are doing. At the other end of Europe another island economy **Iceland**, imposed capital controls in 2008 – controls which are still in force today.

A study in how to make things even worse

A euro in Cyprus is now not the same as a euro in Germany or France – because despite the rhetoric regarding monetary union you can't use a euro in Cyprus. The realization of the dream of seamless cross border flows of funds and people throughout the EU has proven unworkable.

Dutch Finance Minister and president of the **Euro Group Jeroen Jijsselbloem** shocked markets earlier in the week by proclaiming "*the Cyprus model*" sets a "*new template*" for dealing with dead banks, thus immediately freaking out Italy and Spain, two countries noted for their culture, music and dead banks. Jijsselbloem was quickly hushed up and officials scrambled to release new statements claiming his comments were "*out of context*." Such clownish reversals and contradictions from those that govern Europe are doing much to destroy what very little confidence is left in the enterprise and makes us question if, indeed, there are more jackasses in Brussels than those roaming around the island of Cyprus itself.

Looking far ahead, the EU has only "loaned" Cyprus €10 bn euro – and most analysts agree more will be needed as the Cypriot economy shrinks by up to a third. This first tranche of blood money is equivalent to 50% of Cypriot GDP. With Cypriots now having to rely on selling postcards and giving mule rides to tourists to earn money, that €10 bn, like trust in the EU, is gone for good.

The solution

Belief in banks has probably vanished for a generation or two in Europe and Spanish mattress company **Micholchón** sees an opportunity:

"*The people do not sleep well. We have the solution*."

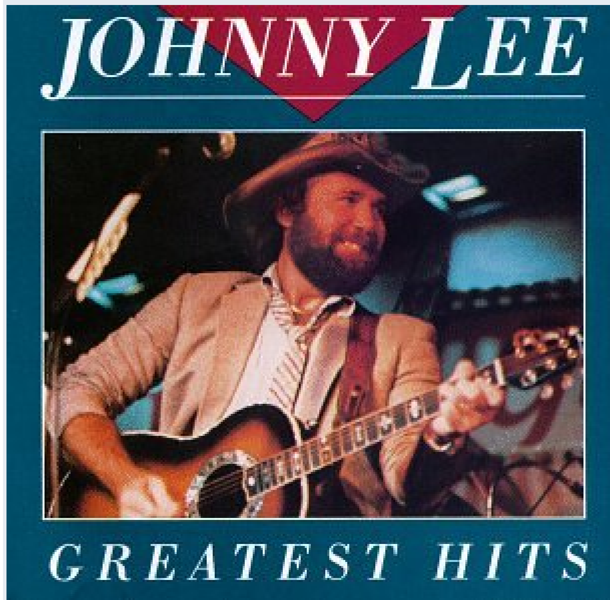
We now know European banks are No place to keep your hard-earned savings. Yes, it is time to buy a mattress with a safe inside.

"*You will sleep well with your money close to you and the banks far away*."

Check it out and the dramatic video (here).

Research

"I was looking for yield in all the wrong places
Looking for yield in too many faces…" – **Johnny Lee's** financial advisor



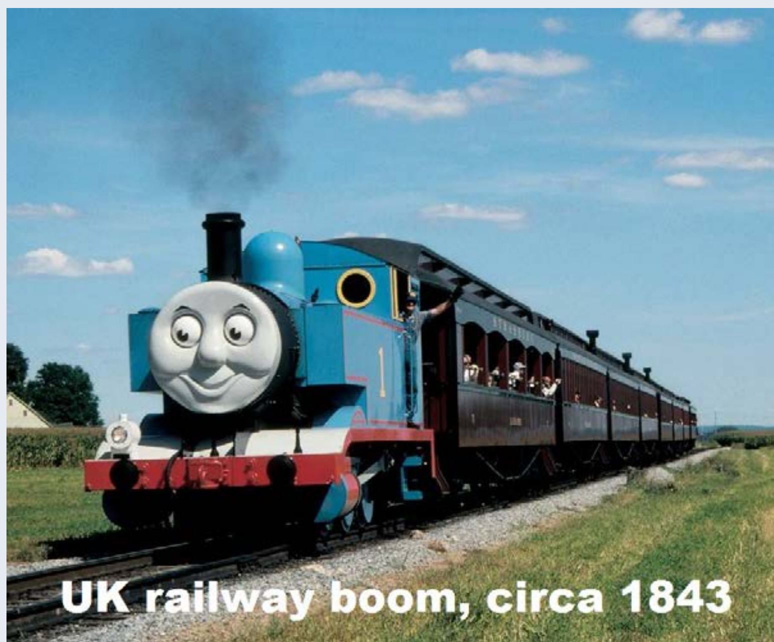
Living in a yield-starved world makes high dividend paying stocks more attractive than would normally be the case. Interest rates crushed down to zero by the tectonic pressure of Federal Reserve action provide the "beer goggles" necessary for investors to make rash decisions. The attractions are many, the pitfalls equally so.

History has shown that in a declining interest rate environment, higher-risk borrowers find it easier than before to come to the debt market at lower premiums to the current risk-free rate. In the US, the spread between investment grade corporate debt and junk corporate debt ("*high yield*," in polite company) has collapsed from 450 bps last July to just 250 bps now. One of the larger construction companies in the US, MasTec **(MTZ US)** with a debt rating of BB- (three notches below investment grade) has just sold $400 mn in new debt at a low rate of 4.875%. In Asia, junk-rated companies currently pay an average of just over 6%. At the beginning of the year we saw evidence of yield lust when the junk market soared and flaky companies were able to sell debt to an eager audience hungry for yield at 6-7%. **Agile Properties (33383 HK)** even issued a $700 mn perpetual for just 8.25%.

On the sovereign side there is a scramble like never before for EM debt, as well The last two years have seen brand new entrants to the debt market, such as **Paraguay** (!), **Zambia** (!) and **Belarus** (!!). Reportedly, even **Papua New Guinea** and **Rwanda** are planning roadshows now.

Support?

The railway boom in the 1840s in the UK is a good example of a similar period in history of investors "yielding" to temptation against their better judgment. Way back in the day, investors bought equities for the yield and expected little or no share price appreciation. Equities were (wrongly, it turned out) perceived more like bonds.



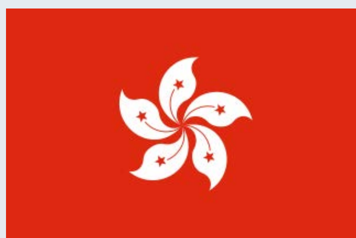
Despite falling profitability in the sector due to rising construction costs and more competition, railway companies "kept investors sweet" by continuing to pay high dividends. The bigger companies even maintained a dividend between two and four times the prevailing rate of interest ("*History of Institutional Investment*," Riley, Napier). Interest rates began to rise during the boom, which revealed that many companies had been paying dividends out of capital rather than earnings, an unsustainable practice. Even the more profitable companies were unable to continue paying high dividends as interest rates continued their ascent and costs followed closely behind. Fraud was exposed. Railway shares collapsed and investors living off the dividends were wiped out. So much for the yield support.

Value indicator?

For those who like to include fundamental analysis in their criteria for picking stocks, dividend yield is also a poor indicator of value. Smaller, growth-oriented companies rarely pay dividends but can still be "undervalued." Only by looking at the dividend yield of the entire market and comparing it to past cycles can some approximation of "value" be estimated. Yet, market yields have been declining for 200 years, so that doesn't always provide an accurate yardstick. Dividends have also become less popular due to the rise of corporate share buybacks, which are a more tax-efficient way of returning cash to shareholders.

The current dividend yield of the S&P is 2.12%. That sounds low – does it mean the market is overvalued? No. According to data compiled by **Dimson, Staunton** and **Marsh**, the US dividend yield was 7.2% in 1950 and hit a low of just 1.1% in 2000 (Actually, while 2000 was a good time to sell stocks, 1950 was an excellent time to buy stocks). Since dividend yield for the market overall does not mean revert it has little use as a predictor of future index returns. <u>For stocks, however, an unbelievably high dividend yield can trap the unwary</u> and should be seen as more of a flashing red light for investors. I remember in 2008 when the reported dividend yield for Citibank hit 14%. Well, they weren't going to pay that, were they!

Warren Buffet famously refuses to pay a dividend at **Berkshire Hathaway (BRK/A US)** arguing greater shareholder returns on capital can be created (as measured by rising book value) through Berkshire's insatiable appetite for corporate acquisitions. **Microsoft (MSFT US)** didn't even start paying a dividend until 2003 – which was a pretty good time to get out of the stock as it has gone nowhere since, as can be observed in the chart above.



Traditionally, mature markets have paid out more earnings in the form of dividends to investors than "growth" markets. Yet now, the thickest dividend yields are to be found in emerging markets. The current dividend yield for the **Hang Seng Index** is 3.22% - a full 50% greater than that of the S&P 500. The Top Five high yielding dividend (indicated) stocks with a market cap of US$500 mn or more currently are:

Stock	Code	Div Yield
1) **361 Degrees**	1361 HK	7.72%
2) **Smartone Tel**	315 HK	7.71%
3) **Xtep Int'l**	1368 HK	7.63%
4) **Bosideng**	3998 HK	7.47%
5) **Hopewell Hldg**	737 HK	7.19%

Those higher yields can set you up for buying some unattractive businesses. If that doesn't make one pause, the next step is to see how sustainable these high dividends are. I used BBG's cash dividend coverage ratio (the inverse of the assumed payout ratio) and found the following:

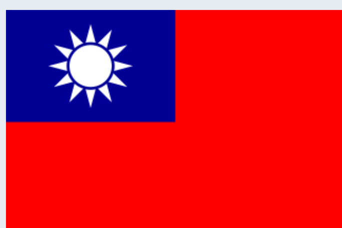
361 Degrees dividend is the "safest" with a coverage ratio of 2.44x

Xtep and Bosideng had ratios of 1.65x and 1.32x respectively.

The high cash dividend is most under threat at Smartone and Hopewell with coverage ratios only at 1x. Smartone's share price just hit a 52-week low and while the company has HK$1.3 bn net cash on the balance sheet they are raising money after successfully bidding for 2 x 10 MHz at the 2600MHz frequency band in auction for HK$640 mn. Recent results showed falling profitability due to greater consumer awareness of insidious roaming charges and as a dividend yield play one needs to be careful. Those

indicated dividends may be cut to help pay for spectrum expansion.

Hopewell Holdings is highly leveraged with a net D/E ratio of 72%. Profitability is declining and taxes are rising. Sustaining their 98% payout ratio may not be difficult but earnings have been falling for four years in a row so the dividend paid this year could yield more like 5% than the estimated 7.19%.



The reported dividend yield for the Taiwan equity market is similar to Hong Kong; 3.38%. Using the same screen parameters for Taiwan *yields* us the following Top Five:

Stock	Code	Div Yield
1) **HTC**	2498 TT	16.67%
2) **Amtran Tech**	2489 TT	10.55%
3) **Huang Hsiang**	2545 TT	9.57%
4) **China Petro**	1314 TT	9.00%
5) **Far Glory**	5522 TT	8.86%

What is the assurance of high dividend continuity? Aside from China Petrochemical, which has a cash dividend coverage ratio of 3.16x, the others are below two times, with **HTC at 1.85x** and Amtran at a very low 0.76x. If Amtran actually pay that dividend retained earnings will have to be used.

Despite Bloomberg forecasts, a dividend yield of 16.67% for HTC stands out as "*it ain't gonna happen*." Let's examine why.

Former high flying HTC has been beaten through the ground by Android competitor **Samsung** and is the most shorted/hated stock in Taiwan. HTC's market share globally in high-end smartphones has cratered from almost 11% in Q2 11 to 4.3% now, and Samsung and **Apple** own 80% of the market. While reviews of their new *HTC One* phone seem positive and a record high number of 185 operators will carry the product, we need to see Samsung or Apple really stumble before a gap opens for HTC to exploit.

Despite net cash of US$2.6 bn nesting comfortably on the balance sheet, dividends have to be paid out of earnings, unless a capital reduction is completed (as a wise client pointed out to me). In 2011, HTC had its best year, earning NT$61.975 bn and paid a

NT$40 per share dividend, for a payout ratio of 54.5%. 2012 was not so rosy and HTC's earnings disappointed each quarter except for Q4 when they beat lowered expectations but then gave much reduced guidance as the company anticipates a sixth straight decline in quarterly sales. If the same payout ratio of 54.5% is maintained on preliminary net income for 2012 of NT$16.771 bn, the dividend to be paid this year will be NT$9.14 a share, giving you a dividend yield of …3.6%. This reminds us of the first rule of investing for dividends: if the reported dividend yield is unbelievable – don't believe it.

Taiwan? *Where?*

While not many investors, institutional or private, look at the Taiwan equity market anymore as the country has gently declined into the investment equivalent of mental illness, there are still some trying to make a go of it. One of the few die-hards left recently penned a letter to Taiwan's president, **Ma Ying-jeou** inviting him to tea, which he sent to me.

In his letter, he explains to the President, "*interest [in Taiwan] is declining*," and it has narrowed, "*one-third of all foreign portfolio investment in Taiwan is in TSMC and Hon Hai*." He suggests a meeting between the two of them to explore ways, "*in which we could attract foreign capital back to Taiwan*."

Some of the points this fund manager wants to raise with President Ma include the ridiculous restrictions on Mainland Chinese investment in the economy, including tourist arrivals. "*Doesn't Taiwan need all the Chinese tourists it can attract?*" he asks. "*Is a Taiwanese bank truly a strategic asset?*"

The letter ends optimistically, "*I look forward to our discussion*."

Moving on to Korea, traditionally not a place to look for hockey players or high dividends, the equity market average dividend yield is just 1.2%. The Top Five in Korea:

	Stock	Code	Div Yield
1)	**Mac Korea**	088980 KS	7.11%
2)	**KT Corp**	030200 KS	5.74%
3)	**SK Telecom**	017670 KS	5.33%
4)	**Doosan Corp**	000150 KS	4.76%
5)	**Meritz Fire**	000060 KS	4.33%

Macquarie Korea Investment Fund has a market cap of $2.2 bn, AVDTO of $6 mn and operates 11 toll roads, 1 subway and 1 port in Korea. The fund declares dividends in June and December and distributes almost all earnings to maintain its tax-exempt status. MKIF has been de-gearing (40% currently) and recent results (here) were good with net income up 16% and expenses down. The cash dividend coverage ratio, however, is below one: 0.91X, meaning the reported yield would require a payout ratio of over 100% and is therefore probably slightly exaggerated.

The two telcos have a coverage ratio of 1.9X and Doosan Corp is perilous at just 1.1X. Meritz is sitting pretty with a cash coverage ratio of 3.1X and that dividend therefore looks the most secure.

Other emerging market dividend yields do not show much of a pattern and are all over the place. **India**, like Korea, has chapati-thin dividends, with the market yield reportedly just 1.62%. **Singapore**'s Straits Times Index yields 2.84%, the same as **China**'s Shanghai Composite Index. **Brazil**'s Bovespa is at a more generous 4.75% and **Russia**'s Micex yields 4%.

Investing just for the dividend can convince investors to buy companies that may not have great businesses. We saw during the financial crisis many pensioners were wiped out who had held Citibank shares for decades, happily living off the dividends. As I reflect on that, I realize while the idea of owning high yielding stocks in a low interest rate environment is attractive, some of my worst investment decisions have been based on yield lust. Time for a cold shower.

Sinorama

While China continues to foul the air and water of her own territory (and deny it), her neighbors are becoming annoyed. We wrote about **Japan** instituting new pollution standards and activity bans to deal with Chinese pollution hovering over their islands. Korea suffers the same problem. The part of Russia most susceptible to Chinese pollution is **Siberia** where bears and empty vodka bottles outnumber the people. This probably has played some part in Russia's reticence to comment on the issue. That may now change.

It appears that a piece of Chinese space junk recently smashed into a Russian satellite severely disturbing its orbit and speed of rotation. Scientists have investigated the incident and concluded that the orbital hit and run was caused by debris from the detonation of China's **Fengyun 1C** satellite in 2007. **NASA** estimates that explosion generated over 35,000 pieces of space junk – or the "largest debris-generating event" in space above Earth since the meteorite wiped out the dinosaurs 66 mn years ago. There was no comment from Beijing as space pollution is also a state secret.

Is China's GDP data accurate?

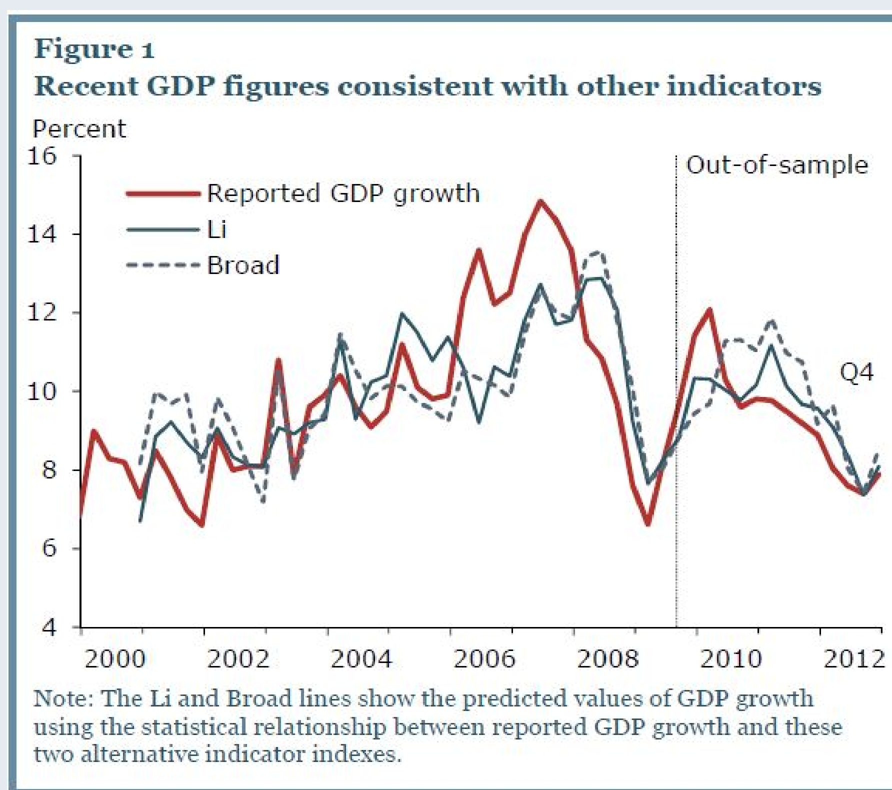
Pollution data manufactured by China is intentionally inaccurate but how accurate is economic data that China produces? Many, including the **US Federal Reserve**, have doubts on the veracity of such things as China's reported GDP numbers. Most emerging market economies publish quarterly GDP data, which includes detailed expenditures in real and nominal terms. China, unusually, does not (others in this small camp include transparency winners like **Kazakhstan** and **Nigeria**). The lack of detail gives economists only a rough idea of where growth is coming from, or not coming from.

WikiLeaks insight

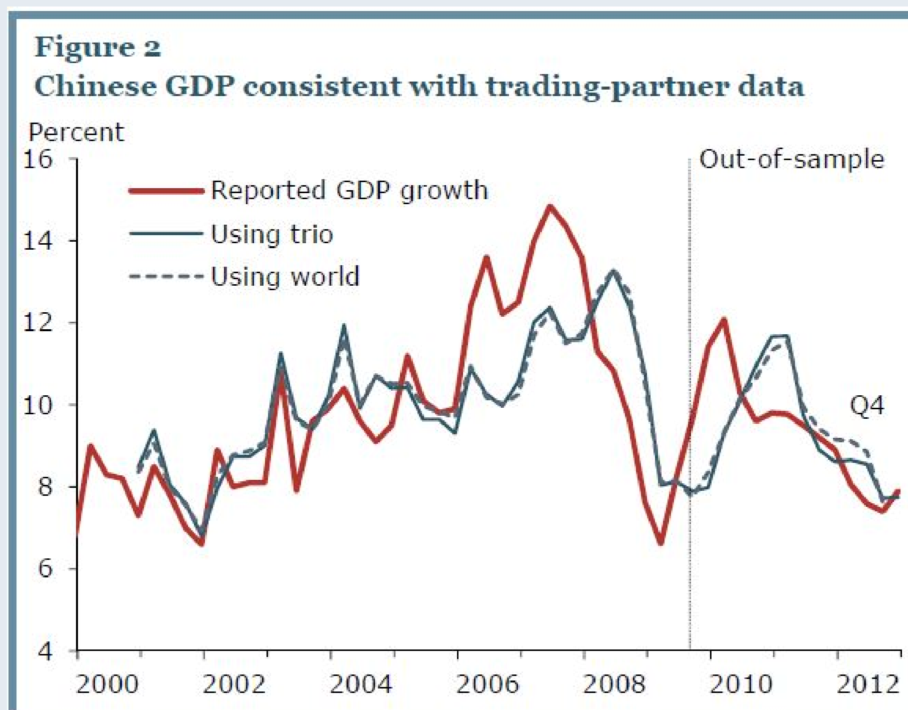
In a **WikiLeaks** diplomatic cable from 2007, then Vice Premier **Li Keqiang** stated, "*GDP figures are 'man-made' and therefore unreliable*." Mr. Li prefers to get his read on the

economy by looking at electricity production, rail shipments and loan disbursements.

In a just published "*Economic Letter*" by the **Federal Reserve Bank of San Francisco** (here), the issue of China's GDP number accuracy was investigated. The bank used alternative indicators of Chinese economic activity to see how that matched official data. Using the data the now Premier Li Keqiang prefers (see "Li" in chart), researchers found a close match to official GDP figures. Using other government data, including consumer sentiment, construction air passenger volume, etc. ("Broad"), it was determined Chinese GDP figures are indeed accurate as published.



To get away from the problem of using Chinese government statistics to measure Chinese government statistics (which can be about as meaningful as listening to one journalist interview another journalist), the study also looked at import and export figures reported by China's major trading partners. Such data cannot be "fudged" by Beijing. The Federal Reserve Bank of San Francisco found, in statistical terms, trading-partner data are "significantly and positively correlated" with Chinese GDP and industrial production.



It is probably safe to conclude, while there are gaps in information, over longer time periods official GDP data as reported from China is not too far off the mark.

Looking ahead at China GDP for 2013, Mirae economist **Joy Yang** concludes the draft budget just presented by the **Ministry of Finance** to the **National People's Congress** to be "*Big thunder, little rain*." In her piece of the same name (here), Joy has cut her 2013 GDP target from 8.2% to 8%. This is because, despite the headlines, after sifting through the numbers she declares fiscal policy for 2013 is really not expansionary, but neutral.

As a percentage of GDP, the headline fiscal deficit rises from 1.5% last year to just 2.1% in 2013. Inflation is not a major concern this year, which she sees to mean no change in interest rate policy either. If this comes to pass, then expectations of a strong China equity market this year may well be misplaced. I know I was hoping for more and may have to revisit my bullish views on the market.

The Last Page

A man visits his doctor with complaints of numbness and pain in his legs, abdomen and shooting up his left arm. The doctor runs a full battery of tests and calls later that week with the bad news:

“I’m afraid we will have to remove your testicles. It's the only way you will ever get better.”
"Oh my God!" the man exclaims. "What should I do?"

The doctor advises that he take some time to come to terms with the reality, have the operation, and then go on a cruise to recuperate.

"When you come back, go out and buy yourself some new clothes and enjoy your new, pain free life," says the doctor.

The man takes a couple days to ponder the situation, realizes that he's not getting better, and goes ahead and has the operation. Soon he books a cruise and recuperates. Not long after he returns he goes down to the local tailor, who he's heard is quite good.

"I'd like a new suit" he tells him.
The tailor squints, eyes up the man, and says, "OK, first the jacket...a 48 long.”
"Amazing!" exclaims the man, as he tries it on... “A perfect fit!"
"The shirt...38 with a 15 neck," says the tailor.
Again, a perfect fit. "Your pants...38 with a 34 inseam" says the tailor, and once again they are a perfect fit when he tries them on.
Finally, the tailor says "now, for the underwear...a 38."
"Nope" says the man. "I take a 36."
"Impossible!" exclaims the tailor, "you're a 38 if I've ever seen one!"
"No! I wear a 36!" yells the man.
"Listen,” yells the tailor, “If you wore a 36 you would have numbness and pain in your legs, abdomen and shooting up your left arm!”

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