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Martin Spring's private newsletter on global strategy

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Emerging Markets Start to Look Attractive

Emerging markets interest those of us who invest internationally because of their obvious attractions. They are high-growth economies driven by both domestic opportunities (rapidly-expanding middle classes) and expanding global trade. They encompass some of the world's most dynamic companies (Samsung Electronics, Alibaba) and some of its largest. Some of the latter are even cheap, with their shares trading on price/earnings ratios of around seven.

However, investors in them have recently been going through hard times. Last year the shares fell on average by 14 per cent in dollar terms, or by twice as much as those based in developed economies.

Emerging markets are sensitive to movements in currencies, especially the US dollar… which strengthened last year. And they're sensitive to what happens in stock-markets generally. When global investors grow cautious, they're keener to abandon holdings far away than those at home, where they're most familiar.

In recent weeks emerging markets have started to perk up. In January the $9 billion that foreign investors poured into China, the most important emerging market, was the largest monthly inflow on record. Investors' rising optimism is attributed mainly to the surprising U-turn towards doveishness by the US Federal Reserve. A lesser likelihood of rising American interest rates is good news for emerging markets.

Is this improving situation mean you should start planning re-entry into their shares? It's a decision that needs to be shaped not only by timing, which now seems to be favourable, but also by whether it makes as much sense to invest in the emerging markets again as it has in the past.

Rajiv Jain, the Florida-based fund manager, has an interesting perspective on why EMs look particularly cheap relative to shares of developed economies. *FullerTreacyMoney* reports him as follows…

"The industries that comprise the emerging markets are primarily autos, oil, steel, lumber – basically old heavy industry – and natural resources. Auto companies sell for less than ten times earnings in the US… and [also] sell for less than ten times earnings in the EMs. Oil companies sell for a low [price/earnings ratio] on the US… and sell for a low PE in the EMs.

"The industries in most emerging countries are those that make money from mining 'things' and making 'things,' whereas the developed countries (primarily the US)

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are comprised of companies that make money from innovation and invention. “You can buy ‘things’ from anywhere, but you can’t buy innovation from anywhere. So you pay a higher PE for a company that is nimble and innovative versus a company that produces the same thing year in and year out, and makes a product you can buy anywhere.”

One problem with that analysis is that almost all the biggest companies in the MSCI emerging markets index are themselves global leaders in innovative sectors such as social media, infotech hardware, e-commerce. Investors can find innovative firms to invest in as easily as in the developed markets (although it may not always be as easy to actually invest in them because of limitations on foreign investors).

In any case, “emerging markets” is a very misleading asset class, which makes it unwise to invest on the basis of trends in them as a whole. Companies of China and just three other Asian economies account for almost two-thirds of the MSCI index. Others whose stock-markets are frequently reported to tell us what is happening in EMs, such as Turkey, Argentina, are so small relative to those of the Asian giants that they have little or no relevance to the rest of the asset class.

The international climate for EMs remains unpromising – moderate but persistent slowdown in China, US policies biased towards quantitative tightening, increasing uncertainties in Europe, tightening liquidity in financial markets.

However, some changes for the better seem likely in the coming months, suggesting some sustainable strength in equities later this year. The US fund management giant GMO was recently reported as having “a heavy weighting of emerging market shares in its discretionary portfolio” but “no American equities.”

Its latest forecast of seven-year annual-average real returns gives EM equities top ratings of 8.2 per cent for the sector as a whole, 10.2 per cent for its value stocks (that is, the cheapest). Those forecasts compare to forecasts of just 2 and 3.9 per cent respectively for large “international” (non-American) companies, and negative 2.5 and 0.3 per cent for large US firms.

So… time to build a list of interesting prospects for your portfolio?

Austria’s Erste Group suggests that the trade war “will trigger a shift of production facilities from China to other emerging-market countries.” That could be to the benefit of smaller Asian countries such as Thailand, Vietnam, Taiwan… and also Mexico.

Currently Indonesia, India and the Philippines are the strongest markets in Asia. Later this year I expect China to take the lead, lifting its Asian neighbours but also Latin American countries, for whom it’s a major trading partner, and perhaps also Australia/New Zealand.

Living in Emerging Economies

By Chad and Peggy Creveling

With increasingly global careers, weak job markets in some developed countries, and retirees looking to stretch their savings and pensions, greater numbers of people are building their lives outside their home countries. In many cases, they end up as expatriates in emerging and developing economies where growth and opportunity seem abundant and the cost of living can be cheaper.

While living, working, and retiring overseas can be a rewarding experience, it is not a decision that should be made lightly. It is one thing to be sent temporarily overseas by a multinational on a full "expat package" that includes a car, driver, generous housing and school allowances, and medical insurance. But it is an entirely different matter to seek your lot on your own or to retire overseas.

Entitlement programs and support systems available in your home country may not be available overseas, and you will likely be unable to tap into home country support systems while living in a foreign country. Without proper planning and an awareness of the challenges of building a life overseas, dreams of a lavish expat existence can quickly turn into a nightmare.

Whether as a retiree or as a professional embarking on an extended stint as an expatriate, here are some things to know as you begin your expat life in an emerging economy.

► **Access to banking facilities and products can be limited**. Establishing a bank account in a developing country can be difficult. In addition to your passport, you may be required to show a work permit and a valid visa, as well as other documents establishing your residency such as a lease document or utility bill. Just having a tourist visa may not be enough.

Even if you can open a bank account, your non-working spouse may not have access if joint accounts are not offered or if your spouse does not qualify.

Additionally, the range of banking products you are used to may not exist, or if they do, you may not be able to access them as a foreigner. For example, most countries do not offer 30-year fixed-rate mortgages. It can be difficult, if not impossible, for foreigners to borrow in local currency.

For a number of reasons, having a local bank account can still make sense, so you will want to research what is involved in advance.

► **Inflation is generally higher than in developed countries**. While living overseas, especially in one of the emerging markets, can seem cheap at first glance, the reality is often different. The cost of a middle- or upper-middle-class lifestyle may have been bid up by lack of supply, increasing numbers of foreigners, and generous corporate expat packages.

By some accounts, Luanda, Angola, is one of the most expensive cities in the world for expats — more so than Hong Kong, Zurich, London, or Sydney. Even in traditionally inexpensive Thailand, some items such as cars and wine may be more than double what you would pay in your home country.

Inflation in developing economies can also run much higher than in the developed world. For example, a recent survey by Mercer, a human resources advisory firm, found that the cost of living for expats has been increasing substantially in traditionally inexpensive cities such as Mumbai, Bangkok, Jakarta, and Hanoi. What was once affordable can quickly become untenable, particularly for those on a fixed income.

► **Currencies tend to be more volatile**. The exchange rates of emerging-market currencies tend to be more volatile as measured against developed-country currencies.

This point can be important, as very rarely do expats live entirely on the local economy and generate earnings in the local currency. Often, they either are supported by earnings in their home currency or want to preserve the ability to return to their home country or a third country. Additionally, imported goods are often priced (directly or indirectly) in developed-world currencies such as US dollars.

Managing currency risk is paramount and can be difficult, especially for those on fixed foreign-currency pensions. Expats will want to avoid the situation where a combination of inflation and an appreciating currency prices those on a fixed income out of their intended retirement home.

► **Investing can be expensive and risky**. Often, expats invest overseas to avoid home country taxes. In many cases, though, local capital markets are less developed and less regulated, resulting in less investment choice, expensive and inferior products compared with home country products, and less investor protection. This can make saving, funding goals, and hedging inflation and currency risk, difficult at best.

Many expats rely on the offshore financial markets for their investment needs, but what they save in home country taxes, they often more than give back in the form of excessive fees. Lack of regulation, investor protection, and predatory sales practices often permeate the offshore financial market, although recent attempts by regulators to crack down and competition are forcing improvements.

For Americans, investing overseas opens them up to a whole range of regulation, punitive taxes, and onerous reporting requirements backed by substantial civil and criminal penalties for failure to comply.

► **Difficulty in owning property**. Expats from developed countries are often surprised how difficult it can be to buy property in an emerging country. In Thailand, for instance, foreigners are not allowed to buy land, which generally precludes them from purchasing a house. They can buy condominiums, however, subject to foreigner/local building ownership ratios.

The lack of a developed mortgage market for foreigners means purchases typically have to be in cash, which constrains an already relatively illiquid secondary market.

Some Americans are also surprised that they are liable for US capital gains taxes on property sold overseas and that movement in exchange rates on both the foreign property and the foreign mortgage can have a significant impact on the taxes due.

► **Difficulty in obtaining adequate insurance**. Like the financial markets, the insurance market in emerging and offshore markets typically offers less product choice, less regulation and investor protection, and greater expenses, than markets back home.

Obtaining adequate medical insurance can be particularly difficult for the long-term expat. Home country policies will often not cover you for an extended time overseas, and offshore or local policies tend to be expensive and restrictive in what they cover.

Many expat policies have age limits and will not cover you after age 70 or so. This can be particularly difficult for retirees. In the past, expat retirees had the option of returning to their home country to access national medical programs, but many countries are shutting off that access for expats. Likewise, Americans are unable to use Medicare overseas.

In addition to healthcare, other policies — such as long-term-care insurance, long-term disability, and term life insurance — can be non-existent, restrictive, and expensive. However, there is no shortage of fee-laden insurance-linked investment and savings schemes!

►**Increased tax complexity**. Expats, especially Americans, face increased tax complexity compared with their home country compatriots. Not only can they be taxed by their home country, but also by their country of residence and other countries where they may own assets.

Sorting out the intersection of conflicting tax codes and tax treaties can be complicated and time-consuming. In the past, many expats typically ignored the situation, but a renewed emphasis on compliance by many governments around the world is now making this impossible.

► **Limited availability of retirement plans, pensions, and other benefits**. Expats working overseas often have no access to national pension schemes or other government-incentivized retirement savings structures. While working overseas, particularly for a foreign company or their own business, expats may not be paying into Social Security or other home country national pension systems, which means they will not receive the benefits when they retire.

Even if they can participate in local savings-oriented retirement schemes, these schemes are typically inadequate and, for Americans, generally not recognized by the IRS, and thus taxable. Offshore products billed as "pensions" bear little resemblance to national pension schemes and are certainly no replacement.

Without access to the same type of retirement support structures offered in their home countries, planning for retirement becomes even more important and difficult for expats.

► **Increased complexity of estate planning**. Expats must often consider estate planning from the multiple conflicting perspectives of their home country, their country of residence, and any other where they may have significant assets. Many expats are surprised to find that while they are considered non-residents of their home countries for income tax, this is not the case for estate/inheritance tax, which is often based on citizenship rather than residency.

It can be particularly important to have a coordinated set of estate planning documents when subject to multiple jurisdictions with differing property disposition and minor custody laws.

Planning can be further complicated by the lack of trust law and recognition of powers of attorney, living wills, and healthcare directives in the emerging markets.

► **Limited availability of professional resources**. Cross-border planning issues can be complex, and too few professionals are serving the growing expat population beyond those offering services to the ultra-wealthy. Local professionals serving the domestic population are often poorly equipped to deal with expat

cross-border planning issues, as are home country professionals who lack local knowledge and global perspective.

Professionals such as estate lawyers, tax advisors, financial planners and other service professionals so readily available back home are often few and far between in the emerging markets — although there doesn't appear to be any shortage of people selling real estate, insurance, and offshore investment schemes! Unfortunately, selling a financial product or asset falls far short of the type of comprehensive, coordinated planning that is needed to plan a secure future overseas.

While an expat life can be rewarding and adventuresome, it comes with challenges, especially expat life in the world's emerging or developing economies. While this list is not all-inclusive and each country will have its own planning challenges, this article touches on some of the main issues faced by expats as they embark on the adventure of overseas living.

As with most planning, solid financial planning done in advance can make life easier. This is all the more the case for expats who live outside of the financial infrastructure and protection that their home countries may provide.

The Crevelings are Thailand-based CPAs who advise expats on personal financial planning and investment. To learn more, visit their website www.crevelingandcreveling.com.

Smart Investing

Here are four rules from Bill Ruane, the late American businessman, investment manager (Sequoia Fund) and philanthropist…

Buy good businesses. The single most important indicator of a good business is its return on capital. In almost every case in which a company earns a superior return on capital over a long period of time, it is because it enjoys a unique proprietary position in its industry and/or has outstanding management.

The ability to earn a high return on capital means that the earnings which are not paid out as dividends but rather retained in the business are likely to be reinvested at a high rate of return to provide for good future earnings, and equity growth with low capital requirement.

Buy businesses with pricing flexibility. Another indication of a proprietary business position is pricing flexibility with little competition. In addition, pricing flexibility can provide an important hedge against capital erosion during inflationary periods.

Buy net cash generators. It is important to distinguish between reported earnings and cash earnings.

Many companies must use a substantial portion of earnings for forced reinvestment in the business merely to maintain plant and equipment and present earning power. Because of such economic under-depreciation, the reported earnings of many companies may vastly overstate their true cash earnings. This is particularly true during inflationary periods.

Cash earnings are those earnings which are truly available for investment in additional earning assets, or for payment to stockholders. It pays to emphasize companies which have the ability to generate a large portion of their earnings in cash.

Buy stock at modest prices. While price risk cannot be eliminated altogether, it can be lessened materially by avoiding high-multiple stocks whose price-earnings ratios are subject to enormous pressure if anticipated earnings growth does not materialize.

While it is easy to identify outstanding businesses, it is more difficult to select those which can be bought at significant discounts from their true underlying value.

Price is the key. Value and growth are joined at the hip. Companies that could reinvest consistently for a rate of return twice that of interest cost deserve a premium.

Why Gold Is Looking Better

Central banks seem to reckon that the yellow metal is a good investment. They're buying it for their reserves at the highest rate for almost half a century. Last year their net purchases reached $27 billion – 74 per cent more than in 2017.

Russia, Turkey and Kazakhstan were the biggest purchasers as the deteriorating political climate spurred them to convert some of their foreign reserves out of dollars. Hungary increased its bullion holdings tenfold. Even Poland is buying tons of gold.

It's clear that the down-trend in gold prices since 2011 came to an end last year. The metal's price has been rising steadily since mid-August. Where is it heading this year?

"The macroeconomic and geopolitical climate is conducive to continued gains in both gold and silver, and the precious metals equities," says American stockbroker Cantor Fitzgerald, given:

► Gold's recent and historical strong performance in a rising interest-rate environment.

► Should inflation expectations rise, this typically is a very bullish leading indicator for gold and silver.

► The inflection point where physical gold outflows from ETFs ceases and inflows resumed was reached in the final quarter of last year and inventory holdings have continued to climb.

► Uncertainty and volatility in global equity, debt and currency markets draw investors to safe havens.

There is considerable upside potential as "precious metals equities are still widely under-owned by sophisticated international investors."

Why There's Scepticism About Renewables

Because renewables cannot supply stable energy flow – often there's no sunshine nor wind – their capacity to replace fossil fuels depends on the economics of storage… that is, batteries.

The industry's promoters base their case on the falling cost of batteries. But how sound is that, asks energy investment consultant Allen Brooks. He points out that in the US Tesla recently raised the cost of its Powerwall 2.0 home battery by 22 per cent, to $6,700. With installation expenses and necessary additional equipment taken into account, total costs for a home battery installation run between $9,800 and $15,800.

"The biggest problem with home battery storage is its limited capacity. Most home batteries only provide about four hours of power, which is considerably less than a full night."

Home batteries "also need to be recharged, which is assumed to happen the next day, with solar and/or wind providing the power. That ignores the possibility of multiple days of no sun and/or wind power."

In South Australia Tesla's sale of a massive battery storage plant "received incredible publicity at the time," but a recent heat wave triggered a power blackout that threw 25,000 properties into the dark. As the Powerwall only provides power for about 80 minutes, the energy utility had to switch on backup generators fuelled by… diesel.

"This episode," Brooks comments, "may highlight that the nirvana of renewables with battery backup is further in the future than touted by its proponents."

The Mega-Rich Come Under Attack

The hero-worship of billionaires that has dominated media coverage for so long is rapidly turning sour.

Initially it was those on the Right who were enraged by the way many of them – George Soros, for example – poured their seemingly unlimited wealth into causes favoured by Leftists and Centrists. Now it's the radical Left who have turned against the super-rich. The Democrats' rising star, Alexandria Ocasio-Cortez, wants to tax annual incomes above $10 million at 70 per cent.

Billionaires have started to become targets of scorn: Starbucks' creator Howard Schultz has attracted more mockery than praise with his strange bid for the Democrats' presidential candidacy. Jeff Bezos of Amazon has attracted the kind of sexual muck-raking more usually associated with Donald Trump.

What's wrong with billionaires which has made them targets of opprobrium?

Merryn Somerset-Webb, the always-interesting commentator of *MoneyWee*k, says: "Part of what's wrong with a lot of them is the fact that (with many honourable entrepreneurial exceptions) they often exist as a result of mismanaged monetary policy (free money can do a lot if you use it right); badly thought-out regulation; politically unacceptable rent-seeking; corruption;

asset bubbles; a failure of anti-trust rules; or some miserable mixture of the lot.”

Investing More Successfully

Here are some guidelines from the well-known commentator Jason Zweig:

► Always take a comprehensive view. Consider your total net worth, not changes in individual holdings.

► Hope for the best but expect the worst. Diversify and learn market history.

► Investigate, then invest. Study the company as a living corporate organism.

► Never say always. Never invest more than 10 per cent in anything, and make sure you always have plenty of dry powder.

► Know what you don’t know. Don’t be overconfident.

► The past is not prologue. What goes up must come down. Eventually everything reverts to the mean.

► Weigh what they say. “Experts” rarely have the track record to match their reputation.

► If it sounds too good to be true, it probably is.

► Costs are killers. Avoid fees and avoid trading.

► Don’t put all your eggs in one basket.

Organ Harvesting

There’s increasing international focus on the way China appears to be killing off its political prisoners to harvest their organs.

The government denies that there’s any truth in the allegation. However human rights investigators say anything from 60,000 to 100,000 organs are transplanted every year in Chinese hospitals.

Where do they come from?

China has no tradition of voluntary organ donation and its officially reported figures for donations fall far below the numbers of organs that are actually readily available.

In advanced Western countries, where the business is tightly regulated, patients have to wait months, even years, for transplants. In China they are offered matching replacements within days. It’s a hugely profitable business for the surgical teams.

There must be a major involuntary source of organs. Investigators conclude that it’s prisoners of conscience – particularly followers of the Falun Gong sect, Uighur Muslims, Tibetan Buddhists and “underground” Christians -- who are the main source. They’re executed on demand as hospitals call for supplies.

Tailpieces

Asian labour: In one respect, it isn't as cheap as it seems. Severance costs when workers are retrenched are extremely high in some Asian countries, offering employers good reason to avoid hiring staff, while making maximum use of casual workers.

According to a World Bank study, in Indonesia employers have to pay an average of 58 weeks' salary to each worker made redundant. In Thailand the average is 32 weeks', in Vietnam 25. In Hong Kong, however, the payout is only one week; in Australia nine weeks'.

Clean energy: Despite all their virtue-signalling talk about focus on renewables, the world's major oil and gas companies are spending collectively only about 1 per cent of their current budgets on clean energy says CDP, an information agency.

This is unlikely to change, says Ignacio Galan, head of the Spanish utility that is the world's largest wind power company, as returns on oil investments far exceed those typical of wind and solar projects – 15 to 20 per cent versus 8 to 9 per cent.

Wise words: *Most of economics can be summarized in four words: 'People respond to incentives.'* Steven Landsburg.

Martin

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