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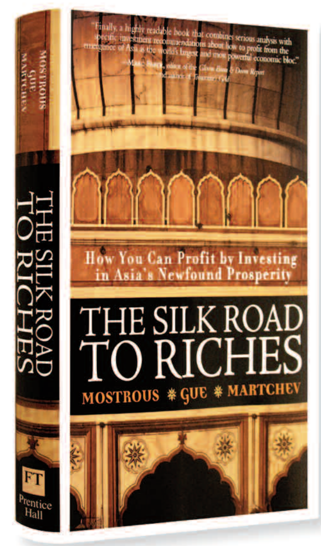
Personal Finance

How You Can Profit by Investing in Asia's Newfound Prosperity

The Silk Road To Riches



By Yiannis G. Mostrous,
Elliott H. Gue,
and Ivan D. Martchev

THE SUMMARY IN BRIEF

The original "Silk Road," a vast network of ancient trade routes, connected Asia with the West. Goods and ideas traveled this road enhancing the lives of millions of people. A Silk Road for a new era was begun in May 2005 at the annual meeting of the Asian Development Bank as 13 Asian nations moved a step closer to creating an Asian monetary fund and establishing more regional financial integration.

Asia is now the world's No. 1 growth story. Profits will be made by investing in companies that benefit from Asia's historic transformation. In *The Silk Road to Riches*, a team of world-class financial analysts and newsletter editors point you to the right companies, the right sectors and the right strategies. This is a guide for the long-term investor.

The authors offer powerful support for several provocative claims: that India, not China, is Asia's best investment destination; that the price of gold is poised to explode; and much more. They illuminate global economic changes that will decide the fate of the U.S. dollar as the world's reserve currency and present an overview of crucial global security issues every investor must understand, no matter where they invest.

The amount of analysis and understanding of developing economies presented in this summary will help those who read it to participate in and profit from the enormous transformation taking place as emerging economies develop their respective capital markets.

IN THIS SUMMARY, YOU WILL LEARN:

- How to leverage Asia's accelerating integration into the world economy.
- How to profit from the pressure that Asia's growth is placing on commodities and resources.
- The differences between the Asian super giants, China and India.
- How to anticipate the needs of Asian consumers in a variety of industries.

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THE COMPLETE SUMMARY: **THE SILK ROAD TO RICHES**

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PART I: IT IS ALL ABOUT THE PEOPLE

A New Middle Class

A recurring theory throughout the centuries that has not yielded tangible results has been that Asia can become the engine of global economic growth. Based on a perceived inability of the region to deliver on its potential, many investors resist the idea that Asia can develop a sustainable, consumer-based economic growth model. Such resistance is rooted in the region's well-documented dependence on exports to the Western economies. Asia, in this construct, is destined to remain stuck in a volatile boom-and-bust cycle.

But consider the following set of circumstances: a large population with the demographics of a high savings rate, an increasing bias toward consumption, and the fact that the world needs a new growth engine for the 21st century. These elements portend a rise of the Asian consumer that will transform the global economy.

Looking Back

Few people appreciate the fact that parts of Asia, especially parts of China, Japan and India, were on the same economic level as Europe until the end of the 18th century. This lack of appreciation, coupled with Europe's spectacular economic growth in the 19th century, led to unshakable misunderstandings when the West did business with China in particular.

Of course, this is a two-way street; Asia's own attitudes harmed it numerous times. In the 1990s, Asian leaders and businessmen accepted the theory that there was something unique about Asia that made its economies thrive. But a careful look reveals that the region's success was more the result of good timing than anything else.

The Old East Asia Economic Model

The basis of the East Asia Economic Model (EAEM) is that Asia satisfies the world financial system's demand for a source of cheap labor for developed economies. This EAEM has created huge surpluses in Asian countries, while suppressing demand and limiting their domestic growth to the amount of foreign direct investment it receives and exports. As the Western economies condition themselves to low-priced products, Asia's role in this system is becoming more important.

Both parties — Asian producers and Western consumers — have accepted their respective EAEM roles. The EAEM is based on export volume and depends on foreign demand and foreign direct investment. This giant export machine helps Asian countries grow, while the accumulation of savings by the Asian people allows consumers in the developed countries to expand their seemingly insatiable consumerism to unprecedented levels.

For the time being, Asia gladly serves as the facilitator of Western economic growth. Its economies are growing and modernizing. Yet, the moment will arrive when average Asians will demand more for themselves, and governments will be forced to spend more resources supporting their own domestic economies.

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Time Is On Their Side — The Demographics Of Asia

Asia is home to 3.5 billion people, 57.5 percent of the world's population. Beyond the raw numbers, Asia's demographics are extremely impressive and important. Asia has what researchers call demographic advantage. The region's dependency ratio continues to decrease and the segment of its population in their 30s to 50s (high earners and spenders) is expected to grow dramatically in the next five to 10 years.

Another important factor is lifestyle changes. Many young people in Asia now have a career-oriented singles lifestyle. In Thailand, about 34 percent of households today have no "economically dependent" children as greater numbers of women are entering the workforce while opting for fewer children. As the urbanization of Asia continues, these trends should persist and become the norm.

The Potential and the Challenge

It is true that it will take time for the Asian consumer to replace the American as the primary global consumption driver, and that it will take a lot in absolute terms for Asia's middle class to catch up to Western standards. However, in relative terms, the results so far are impressive and improving rapidly.

A crucial assumption about the region's future spending potential is that, as economies in Asia continue to grow, the income for distribution will also increase, expanding the region's middle class. This is already happening — the income distribution in Asia is improving, a good sign for future consumption, as well as for social stability.

Since 1997, Asia has made great progress in improving its financial system, but the region's sustainable growth requires nothing less than total banking reform. Although Asia needs money for development, it still cannot properly exploit its huge surpluses given the financial system's functional problems. A regional liquidity system must be established so that Asia can use its savings and other funds for investments without the interference of others. Only if Asian governments succeed in this respect will Asian countries and their citizens attain steady economic growth through sustainable domestic demand.

Eventually, Asian governments will be forced — either by social pressure or by economic circumstances — to structurally boost domestic demand. The current model of economic growth will lead to prolonged economic slumps and will create social problems notoriously more difficult to solve than anything else. At a later stage, a structural rise in Asian wages relative to the United States and the developed world may take place. Domestic institutional and individual investors could provide the next level of support for the Asian countries. If governments and people work together, the next investment/consumption boom in Asia can be domestically driven, relative to the real economic situation of each country, and be more sustainable. ●

Asia's Path To Prosperity

The collapse of the Asian economic "miracle" in 1997 was a devastating economic and social shock for the region. Marc Faber, author of *Tomorrow's Gold: Asia's Age of Discovery*, wrote, "I had never read about, or seen the kind of total economic breakdown and wealth destruction — on such a massive scale, in such a short period of time, and against all expectations — as we saw in Asia in the six months following the onset of the crisis." Investors all over the world felt the consequences.

Theories abound as to why the Asian miracle ended in such a spectacular fashion. The most discussed are panic, crony capitalism and moral hazard in lending.
A combination of crony capitalism and moral hazard in lending is the most credible.

Now the question is: Has Asia established the necessary conditions for sustainable economic growth, even in the event of a U.S.-led economic slowdown? The quick answer is yes. The expansion of trade and Asia's growing role in it will prove to be the main force in establishing the region as an important part of the world's economy.

Outsourcing

Outsourcing — an appalling word to millions of people in developed economies — is nothing more than an effort by a company to produce part of its products (in which it has no comparative advantage) elsewhere. Given that consumers have been conditioned to expect lower goods' prices while developing an increasingly lower threshold for pain, outsourcing will continue despite occasional cries over lost jobs and "inferior service" from abroad.

Outsourcing is not confined to developed countries. Outsourcing and reduction in tariffs are two parameters of the intraregional Asian trade phenomenon.
Outsourcing to gain comparative advantage has reached such levels in Asia that companies there outsource among

each other, based on relative position in the production chain. Meanwhile, more than 90 percent of trade among Asian countries is conducted in a context of tariffs between 0 to 5 percent.

Another factor in strong intraregional trade is the steady incorporation of China into the global economic system. China's domestic growth allowed U.S., Japanese and European Union companies to increase their exports during the 2000-01 global economic slump. This made companies around the world realize that there is more to China than cheap production.

Exports and China are the two strongest forces in the Asian growth arsenal, whereas consumption is slowly and steadily growing in importance. Asia is gradually finding itself in a favorable position in the world economy.

A Changing World

The argument that Asia aims to "take over the world" is nothing more than a base appeal to emotion in place of logic. One of the main tenets of this position is that "imports from countries where labor is cheap cause unemployment in the United States." But if developing economies are able to raise productivity to Western standards, wages will rise there too; Japan proved this. Constant change is what capitalism is all about. This is what the "sensationalists" fail to understand: The world will not come to an end, but rather will adjust to the new economic order.

One of the most important changes in the new economic order will be the adjustment in world wages. The Western world will experience decreasing wages, whereas the East will enjoy the opposite. This shift will take place at a relatively slow pace. These changes will coincide with a decrease in asset prices in the West and a corresponding increase in the East because of changing income levels. The benefits will be universal as consumption will increase due to rising incomes and the integration of China and India into the global economy.

Integration into the Global Economy

For Asia to be able to take advantage of the current global economic situation, governments must find ways to create an environment that will foster sustainable domestic demand. Asian countries need to take advantage of their particular indigenous characteristics while focusing their efforts toward domestic investments.

These countries have held their own in manufacturing, but need to move up the chain from low value-added mass manufactured products to a higher pricing-power export industry. They must also take advantage of domestic natural resources and spend money on domestic-related investments. The ultimate goal is to create the necessary conditions for domestically driven economic growth.It remains to be seen whether the respective governments have the capacity, first, to develop this strategy and, second, to execute it.

Wealth distribution is improving in Asia, but financial security remains the privilege of a few. If the improving wealth distribution trends stop, it will be virtually impossible for the scenario thus posited to unfold. But it will also be impossible for governments to continue ignoring their people. This means governments must shift attention to domestic investment in infrastructure, including agriculture, and shift attention from urban centers to rural areas of their countries.

Lessons Learned

Looking at Asia today, there is a sense that many things have changed for the better. Current account balances have gone to surplus, foreign exchange reserves have been rebuilt and dependence on short-term capital inflows has diminished. Positive cash flow has become the name of the game and Asian companies are expected to stay on this course for years to come.

These factors have allowed Asian companies to become more shareholder friendly by increasing dividend-payout ratios. Dividends have grown substantially since the mid-90s and investors can expect dividend growth of at least 7 percent per year in the future. Asian companies now realize that making money is more important than increasing sales at any cost.

The prospect of a crisis of some sort must not be ignored. However, for Asia in general, and China and India in particular, the inevitable downturn should be viewed as a small detour on the way to joining the capitalist economic system.

The Great Comparison — The Elephant And The Dragon

One of the most important international events of 2003 was India's Prime Minister Atal Bihari Vajpayee's state visit to China. During that visit, the two leaders signed a Declaration of Cooperation and nine protocols on bilateral cooperation, normalizing Sino-Indian relations. Two years later, Chinese Premier Wen Jiabao visited India and signed more agreements on trade, border issues and the development of new energy sources.

China's and India's willingness to put aside their historical differences and concentrate on their mutual economic growth is viewed as one of the most important global developments of the 21st century thus far.

India: A Powerful Force

In 1991, India endured its biggest economic crisis; foreign exchange reserves were down to three weeks' worth of imports. With the country on the brink of collapse, drastic change was instituted; the rupee was devaluated, import controls dismantled, duties were slashed, industrial licensing liberalized and capital markets were opened. These pivotal moves allowed India to emerge as a deregulated economy in the global market. In the four years after the crisis, India's economy grew by 6.7 percent per year.

India's progress is not in question. But for the long-term investor, certain characteristics make its story much more interesting and desirable than any other in Asia.

Characteristics of India's economy include:

• Banks in India have been fairly conservative, maintaining the rate of nonperforming loans at a low 8.8 percent of total lending (as of March 2003).

• Its capital markets are among the most developed of the emerging economies and they operate with greater efficiency and transparency than China's.

• The legal system is fairly independent and acts with integrity (although it lacks efficiency). Property rights in India are protected and the rule of law, albeit with a time lag, usually prevails.

• The entrepreneurial spirit of its people is world-class.

Problems Abound

The elected leaders of India seem to have a good reform plan in place. And in India's case, "Reform is about removing the obstacles to it." The main obstacles are corruption and inefficiencies, especially in the state and lower levels of government. Acknowledging that urgent improvements are needed, India made the decision to use part of its foreign exchange reserves to fund domestic infrastructure projects, a government action without precedent in the world, but one that seems unassailable in light of statistics showing that most infrastructure services costs are 50 to 100 percent higher in India than in China.

Democracy and Growth

As progress in India continues, it is the country's middle class — more than 150 million strong — that is most affected by the changes. This is a huge consumption market, but one must always be aware of the potential for social unrest.

The big challenge is to extend the benefits of progress to the lower levels of Indian society; otherwise the country could enter a period of economic destruction and social unrest.

So far, India has followed the correct path toward economic development, one charted by monetary targets (for example, inflation and a balanced budget). This approach, the results of which are less obvious in the short term, is a long-term creator of economic stability and growth.

China: Waking Up

As with almost every other Asian country, China has followed a model of growth based on manufacturing. Therefore, China's immediate economic future is tied to a high degree to global demand and the relentless cost-cutting actions of corporations around the world. The country's low-cost production setup makes it conceivable that manufacturing-related industries can all eventually be relocated to China.

While such a move makes economic sense, not many are willing to discuss the viability of this development given the socio-economic distortions and political costs involved. But two things are certain: The trend is continuing, and China is doing everything in its power to steer the global economy in that direction.

Solving Problems

China has many daunting problems to solve on almost every level of its economy and its society. The challenges faced by the Chinese leadership will require it to be extremely flexible and creative.

The main issues for investors can be reduced to these questions: Have the leaders of the Communist Party understood the problems and decided on a proper course of action, and will they be successful? For investors, direction is far more important than current status, and China is heading in the right direction.

The Time Factor

Some critics maintain that China will be incapable of transforming itself and will eventually collapse under the weight of its internal dysfunctions.

Gordon G. Chang is the most vocal critic and in his book, *The Coming Collapse of China*, he writes: "If China had, say, 30 years, everything might come out right. But whether China is on the right road is not the matter at hand. When historians write the final chapter on the People's Republic, they will say that there wasn't enough time."

Chang's approach centers on the "moral collapse" of the Chinese society and the lack of political reform. His point is that corruption remains the biggest problem the Chinese leadership has to solve. This brings up the point again that investing in an emerging market environment has always entailed danger. However, there are ways for an investor to profit from the changes that are taking place in China even if the current reforms fail and total chaos prevails as Mr. Chang expects.

PART II: THE RISKS INVESTORS MAY ENCOUNTER

Power Games

Global and regional geostrategic developments are of immense importance when making long-term investment decisions. Those who understand the purely economic reasons for the new relationships will prosper.

The resolution or clarification of the following issues will have global consequences:

- China's political ambitions and military capabilities
- India's desire for first-world power status
- The outcome of the United States-Russia-China race for influence in central Asia
- Russia's role as a vital source of energy
- The potential Korean unification
- Iran's importance to Asia
- Japan's future security needs
- U.S. involvement in Asia and how it affects the changing geopolitical landscape in the region.

These issues are interrelated and therefore extremely complicated, but one central conclusion can be drawn: The post-World War II status quo in Asia is unwinding.

Looking at the Long-Term Returns

There are two main categories of stock markets, developed and emerging. Among the developed markets, the United States comprises about half of world stock market value, and the American economy accounts for about a third of the global economy. Due to its sheer size, in the end, everything comes down to the United States. If cracks appear in the U.S. stock market or economy, the world's major markets shake.

The most common misconception about stocks is that their long-term average return is "guaranteed." The most widely advertised long-term annualized return for stock is usually quoted as 11 percent. But, if the market is flat for a decade or two, any substantial deviation from the 11 percent return assumption can be devastating.

Ultimately, stock prices reflect the earnings power behind the companies issuing the stocks. Clearly, stock prices can deviate substantially from the earnings power they represent, but over the long term, that is not likely to be the case.

There are only two ways that stocks can become cheap compared to previous bear market bottoms. Either prices will decline precipitously, on the order of 50 to 70 percent, or earnings and dividends will double or triple in the next 10 years. A probable development in the market cycle is a substantial decline in prices in the next five to 10 years.

Unsustainable Macroeconomic Imbalances

In a perfect world, a free market without intervention would take care of most imbalances in an economy. But when vested interests cross swords, the story changes dramatically.

At present, the United States requires close to $2 billion net inflow of capital every day to finance the trade deficit. No one can say definitively that creditors will stop the financing binge, but, before that number grows to $3 billion, it is likely that our creditors will say, "Enough is enough." It is likely that there will be a crisis by the year 2010 with the trade balance at its current proportion and growth rate.

The large and growing current account deficit can put tremendous pressure on the dollar, which still serves as the reserve currency of the world. If foreign central banks and large institutional investors decide to diversify away from dollar assets — a process that has already stealthily started — that will accelerate the currency decline to crisis proportions. Nothing is worse than a sinking currency to a heavily indebted economy like the United States.

Of note, the United States is the only country that can pay its rising debts with its own currency, currency it prints at its own discretion. Because of this luxury, the macroeconomic imbalances the United States faces will likely become a lot larger, making the unwinding of those imbalances more painful when it happens.

Bubble All the Way

When trying to define a bubble as economic or stock market related, there is always one common ingredient: the extension of too much credit. Ample credit shifts economic activity into overdrive and ends up pouring a lot of money into too many unproductive uses.

A very basic principle describes the unwinding of bubble markets: full retracement to the point where the bubble started. Full retracement for the Dow Jones Industrial Average is estimated to be at the 4,000 level, which corresponds to roughly 500 on the S&P 500 and 800 on the NASDAQ Composite. There is a high probability this will happen within the next five years, 10 years at the most.

PART III: TRENDS OF THE FUTURE

Agriculture, Energy And Metal Commodities

The New Agricultural Revolution

The global agricultural industry is facing a demand crunch of proportions unseen since the Industrial Revolution. China, India and other emerging economies across Asia support a combined population of over 3 billion, more than half the global population.

Fortunately, an agricultural revolution is underway that will allow the global economy to meet these new demands. Vast improvements in transportation and containerized shipping technology allow even perishable items like fruits and vegetables to be transported vast distances at negligible cost. Asia's growing demands for complex items like meats, fresh items and processed and packaged consumables will rely on imports from other regions such as the United States, Europe and Latin America. Key companies producing goods in high demand across Asia are already seeing a massive jump in trade.

Fueling Global Growth

Higher prices are the only proven way to ration demand for any commodity over the long term. Burgeoning Asian demand for energy, coupled with slow production increases in the coming years, means that the era of low energy prices is over.

The Refining Factor — The refining business is booming for one simple reason: Demand for gasoline globally outstrips the capacity to refine crude. In coming years, well-placed refiners will enjoy widening margins.

Coal — Coal remains king throughout most of the developed and developing world. It still accounts for more than half of the electricity generated in the United States and about 40 percent of global electricity generation. It is a particularly important fuel in Asia, accounting for more than 75 percent of electricity generated in both China and India.

Natural Gas — Natural gas has several advantages over oil or coal: There is more of it and it is far cleaner to burn. According to the Energy Information Administration, natural gas will be the fastest growing source of energy globally between 2005 and 2025.

Nuclear Power — The world is rapidly recognizing the advantages of nuclear energy and the industry is entering a period of global growth. This growth is putting a strain on the world's available uranium production capacity.

Renewable and Alternative Energy — The truth is that existing renewable energies, wind, solar and hydroelectric power, will never be able to fully supplant fossil fuels. Expect solid growth for renewable energies but from a low starting point.

Integrated Oil Companies — They offer a little bit of everything: refining, exploration, production and retail sales of petroleum products. The best companies are at the forefront of key trends in the energy markets, including liquefied natural gas (LNG), deepwater exploration and refining capacity.

Asia'a Evolving Economics

A rapidly growing and expanding Asian middle class will start to demand many of the same goods and services as their counterparts in developed Western economies. Asia's enormous middle class will be the largest group of consumers to ever be integrated into the world economy.

In general, the growing consumer base will require increasingly advanced financial services — banking, credit cards and mortgage loans — to manage growing incomes. Consumers will also want to spend their new wealth on clothes, eating out, holidays and entertainment. The financial and leisure industries in Asia will see tremendous growth in coming years.

Travel and Tourism

There are two primary ways to play the Asian travel trend: the airlines that carry all these new passengers and the hotels with large exposure to these markets.

Several airlines using the Southwest Airlines "low-cost" model are springing up all over Asia. That competition will likely prove a boon to the industry in the way of falling prices. As more Asians conclude they can afford to travel, competition will simply fuel growth for the industry.

Rapid growth in domestic travel, business travel and international tourism is driving the hotel market in Asia. The world's largest hotel chain, Intercontinental Hotel Group, has the biggest presence in Asia of any main international chain. Its flagship brand is InterContinental, but it also includes more common worldwide brands such Crowne Plaza and Holiday Inns.

The Necessities

Consumption of packaged and prepared foods, beverages and fast food restaurants are seen as staple products in the Western world and growth in this industry, while steady, is slow. In Asia, revenue growth in consumer staples has soared to double-digits annually in these markets. Coca-Cola, for example, reported sales growth in 2004 of just 2 percent worldwide but more than 20 percent in China.

Consumer products are one industry where Western brands hold a huge advantage over their local domestic counterparts. The best global brands tend to attract considerable loyalty in China and India, even if they cost more than equivalent local brands.

Global consumer tastes tend to converge as consumers reach equivalent levels of wealth. Thus, local foods and tastes, although important, can give way to global food styles and brands.

Western brands hold two major advantages in Asia: branding and distribution. Western companies have the ability to enter Asia with multibillion-dollar advertising budgets and the scope to set up large distribution centers so they can achieve economies of scale and offer lower-cost sourcing for goods.

Retail

The consumer's influence is finally reaching critical mass in most of Asia. As incomes continue to rise in the region, Asia will develop a culture of consumerism similar to what exists in the Western world.

In China, the concept of hypermarts that include a supermarket and a department store rolled into one are growing in popularity. Also, traditional Western luxury brands have made big inroads into the Chinese market for two reasons: Chinese consumers want Western luxury goods to enhance their social image and there are enormous numbers of wealthy Chinese capable of affording luxury merchandise (despite the fact that the rich represent a tiny proportion of the total population).

Another change factor is the rise of women as key consumers in the traditionally male-dominated region. As the spending power of women in general rises, Asian women are increasingly buying similar items as their Western counterparts.

Also, the concept of the big-box discount store (a la Wal-Mart) is spreading. Wal-Mart is expanding its already considerable footprint in China to enhance its supply chain. According to the *China Daily*, if Wal-Mart was a separate country, it would be China's eighth largest trading partner.

Banking and Finance

Robust economic growth and a rising middle class will fuel strong lending growth in both China and India. India however, is likely to see the faster, more sustainable growth as evidenced in its loan to GDP ratio (total loans outstanding in the economy divided by GDP) of 35 percent compared to China's loan to GDP ratio of 140 percent. Also India has agreed to adopt the internationally recognized Basel II accounting standard for capital adequacy by the end of 2007.

Pharmaceuticals and Healthcare

India already has well-developed expertise in the healthcare business. Indian manufacturers account for more than one-third of all filings in the United States for generic drug approvals, and the nation has the highest number of FDA-approved manufacturing facilities outside the United States. Indian drug companies realize they must take the next step and develop their research and development capabilities, because in this regard they have a competitive cost advantage. A handful of foreign companies will benefit from growth in Asia by selling into the market and by sourcing at lower costs in India.

Technology/Outsourcing

China and India are emerging as key centers of technological innovations. The region holds the advantages of education, since science and engineering degrees are popular and the cost advantage, since R&D operations are less expensive in Asia.

Down The Silk Road

What's important to remember is that, given the challenges ahead, a great deal of cooperation is required for the world to be able to embrace the new economic order and continue to prosper. Cooperation will take center stage as people around the world begin to realize that policy inflexibility cannot offer answers to today's complex geopolitical, social and economic problems.