

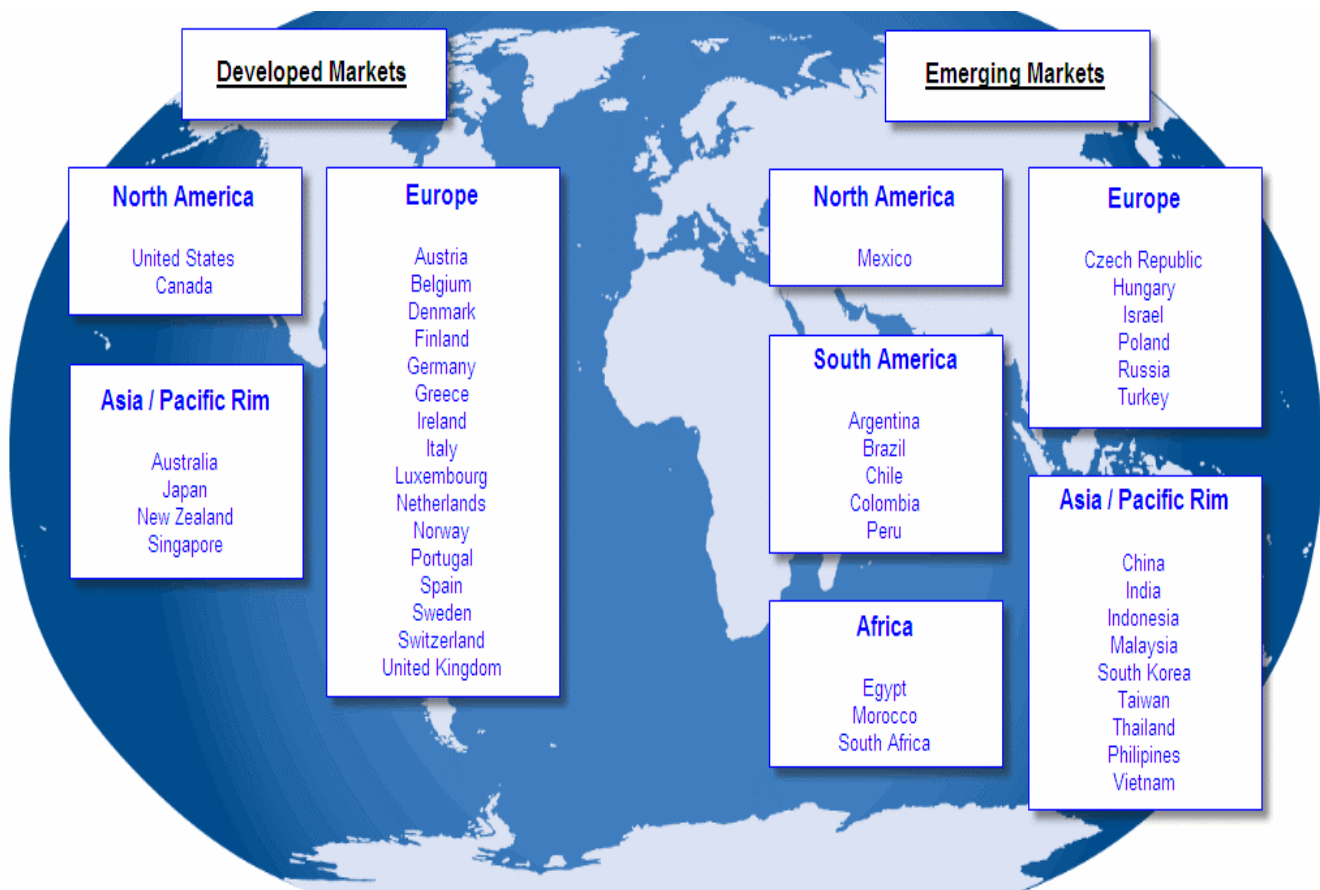


The Starboard Side Report

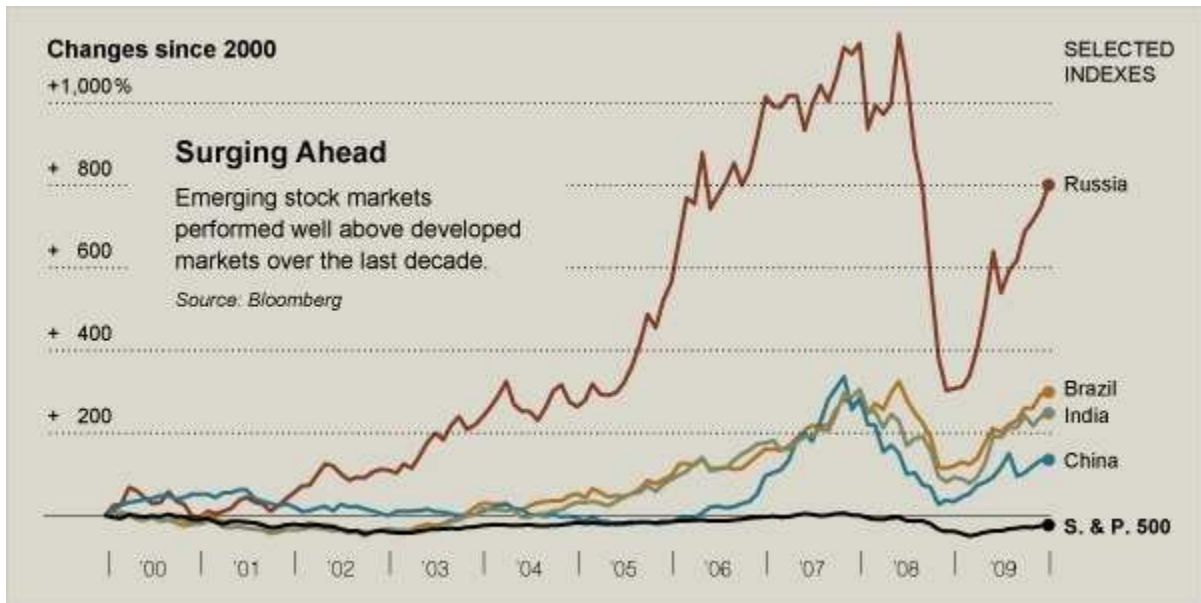
The week ending December 31, 2009

With the calendar about to turn to a new decade we wanted to provide a report that discusses why we see the growth momentum of emerging markets carrying over into the new decade. Just as with precious metals and commodities, we feel that there will be more upside to the emerging markets story in the 2010's. We expect to hear a lot of chatter about emerging markets being in a bubble, but as we mentioned before, there is a big difference between a bubble and a bull market. It is naive to assume that there will be no volatility in the emerging market arena as many of these countries are still relatively immature and in the process of weaning themselves off of excessive US consumer spending. However, even though the transition from exporter to internal consumption may be bumpy, it is an extremely powerful theme that carries major investment implications. Below we will lay out some of the framework for our thinking in this area and briefly touch on why developed economies have become as risky a proposition for investors as emerging markets.

First, let's look at a good breakdown of the developed and emerging world from an investment perspective. Below is a graphic from Dorsey Wright and Associates that serves as a good visual on the developed countries versus the emerging ones.



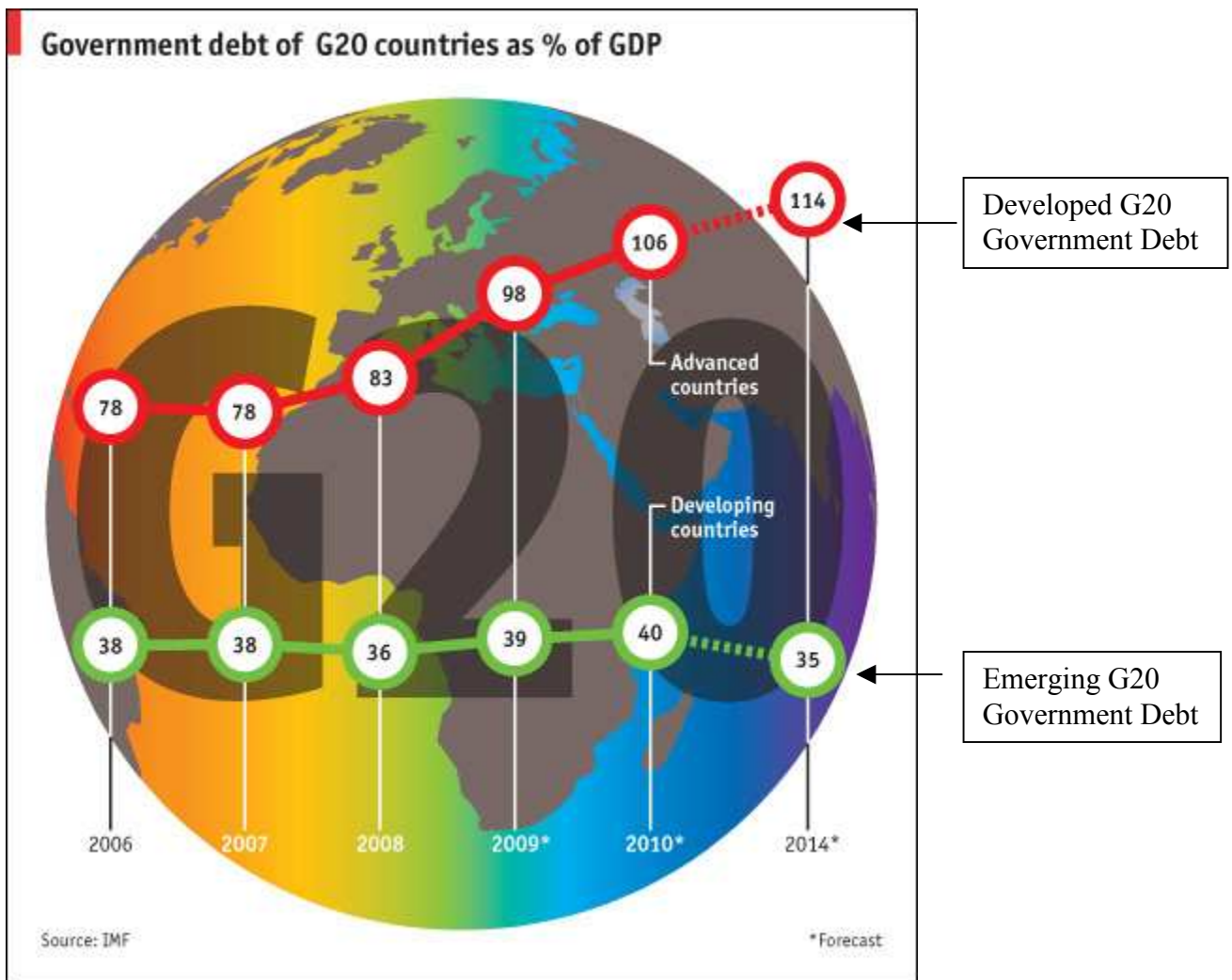
This decade clearly belonged to the emerging markets from a stock performance perspective. In US dollars, the Emerging Market Index gained 130% versus a 23% loss for the S&P 500 and a 5% loss for the MSCI EAFE Developed Markets Index. We can't discuss emerging markets without mentioning the acronym BRIC. This term was coined in 2001 by Goldman Sachs economist Jim O'Neil to cover the fast growing and populous Brazil, Russia, India and China.



Source: New York Times

Above is the performance of the BRIC's this decade. As you can see, they clearly outperformed the US market. The big question going forward is can they continue this torrid growth pace. With over 2.5 billion people, the BRIC nations account for over 40% of the world's population. Should the living standards of these nations even come remotely close to the developed world than we are looking at a future much different from the past thirty years. The emergence of a vast new middle class is one of the reasons the commodity growth story goes hand-in-hand with the emerging markets theme. 10% of the world's population uses 56% of its fossil fuels. As the other 90% of the world climbs out of poverty, the energy resources needed will be well above current capacity. Food and metals will also be in short supply as modernization and new prosperity increasingly lead to a scarcity of essential global resources. We touched on this dilemma in the peak oil report we did a few weeks back. Down the line, emerging world population and economic growth could very well lead to "peak" resources across the board. Copper, zinc, silver, agriculture, uranium and iron ore are some of the other shortages that could develop. This will contribute inflation problems ahead.

Ten years ago the global economic dialogue was pretty much dominated by the G7 which consists of Canada, France, Germany, Italy, Japan, the United Kingdom and the United States of America. However, the G20 is taking center stage and it's much more inclusive- Argentina, Australia, Brazil, Canada, China, France, Germany, India, Indonesia, Italy, Japan, Mexico, Russia, Saudi Arabia, South Africa, South Korea, Turkey, United Kingdom, United States of America and the European Union. From an investment perspective, it was always considered more risky to put money into emerging markets and rightly so given their fragile economic positions. However, even though that mentality persists, there is evidence that points a great economic risk shift occurring right before our very eyes over these past ten years. We believe the argument can be made that there is now as much investment risk in the *developed* world as there is in the emerging world. This view can pretty much be summed up in one word- debt! The chart below from *The Economist* is a good picture of what we mean.



Going forward, the International Monetary Fund (IMF) sees advanced country debt continuing to increase while emerging market government debt is estimated to trend lower. Debt in isolation is one thing, but it must always be analyzed in terms of growth in order to gauge the ability of cash flows to cover interest costs. Things look even more troublesome for developed markets from this perspective because emerging markets are forecast to grow 5.1% in 2010 versus 1.3% annual growth in the developed world. We suspect that the rest of the decade could see this growth discrepancy continue or even accelerate. Again, we want to be clear; it is not that we think emerging markets don't have risk because they certainly do. Volatility will need to be managed quite closely. However, more debt plus slower growth equals increasing default risk for developed countries in the years ahead. Capital tends to gravitate towards growth and pay-up for it. There is still ample room for investors to allocate funds away from legacy positions in debt heavy western economies into more nimble emerging markets. Here is some supporting data:

- Emerging markets are 30% of global economic output (43% at currency parity), yet...
- Emerging markets are only 11% of the FTSE World Index
- Emerging markets are estimated to have only a 5% weighing in US pension funds
- US 401(k) assets are 38.5% in US equities and only 8% in non-US equities

A quote from the blog Systematic Relative Strength sums this up nicely- "For whatever reason (home-country bias, habit, fear...) Americans still are hesitant to allocate much of their portfolio to emerging markets. Perhaps, it is time to expand the investment universe!"

We do not think that the gains we have seen so far in the emerging markets are a bubble in the magnitude of Japan in the late 1980's, technology stocks in the late 1990's or house prices in the US recently. Below we can see that the US cup of prosperity has overflowed dramatically into emerging markets during the past year. Canada and Australia are exceptions to this rule because they are home to a vast array natural resources needed to fuel emerging market growth. We see this trend continuing as we move forward.

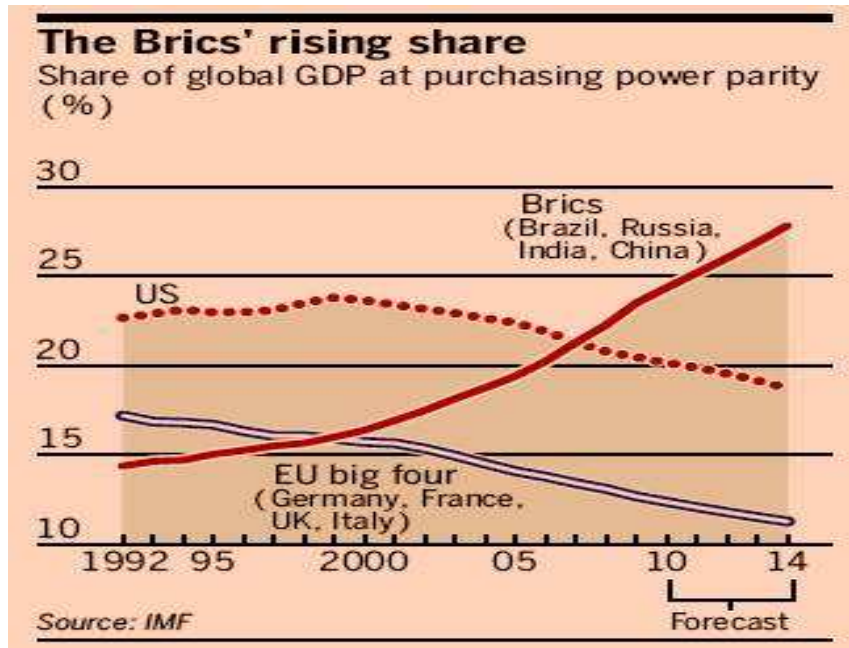
The US is still almost 30% of the world market capitalization.

% of World Stock Market Cap by Country				
Country	Start of Year	Current	Country	% Chg Since Jan. 04
United States	32.75	29.61	Brazil	58.2
Japan	10.28	7.68	Indonesia	52.8
China	5.61	7.27	India	38.8
United Kingdom	6.21	6.49	Australia	35.6
Hong Kong	4.11	5.07	Turkey	32.1
France	4.64	4.15	China	29.6
Canada	3.11	3.45	Russia	26.4
Germany	3.37	3.00	Taiwan	25.1
Brazil	1.84	2.92	Singapore	24.0
India	2.01	2.79	Hong Kong	23.5
Australia	1.98	2.69	Norway	23.1
Switzerland	2.66	2.32	Chile	22.7
South Korea	1.52	1.77	Israel	21.5
Spain	1.99	1.73	Thailand	19.3
Taiwan	1.21	1.52	Sweden	18.6
Italy	1.70	1.49	South Korea	16.7
Argentina	1.10	1.26	Argentina	13.9
Russia	0.82	1.04	South Africa	12.8
Sweden	0.84	1.00	Canada	11.1
Singapore	0.78	0.96	Netherlands	10.1
South Africa	0.76	0.86	Malaysia	6.8
Mexico	0.77	0.80	Belgium	5.7
Netherlands	0.65	0.71	United Kingdom	4.5
Saudi Arabia	0.77	0.70	Mexico	3.8
Malaysia	0.58	0.62	Austria	-1.7
Belgium	0.52	0.55	Denmark	-4.1
Norway	0.44	0.54	Saudi Arabia	-8.6
Chile	0.41	0.50	United States	-9.6
Turkey	0.36	0.48	France	-10.6
Indonesia	0.30	0.46	Germany	-10.9
Denmark	0.44	0.42	Greece	-12.1
Finland	0.49	0.41	Italy	-12.4
Israel	0.31	0.37	Switzerland	-12.7
Thailand	0.31	0.37	Spain	-13.1
Austria	0.29	0.28	Finland	-15.9
Greece	0.29	0.25	Japan	-25.2
Kuwait	0.34	0.20	Kuwait	-42.0

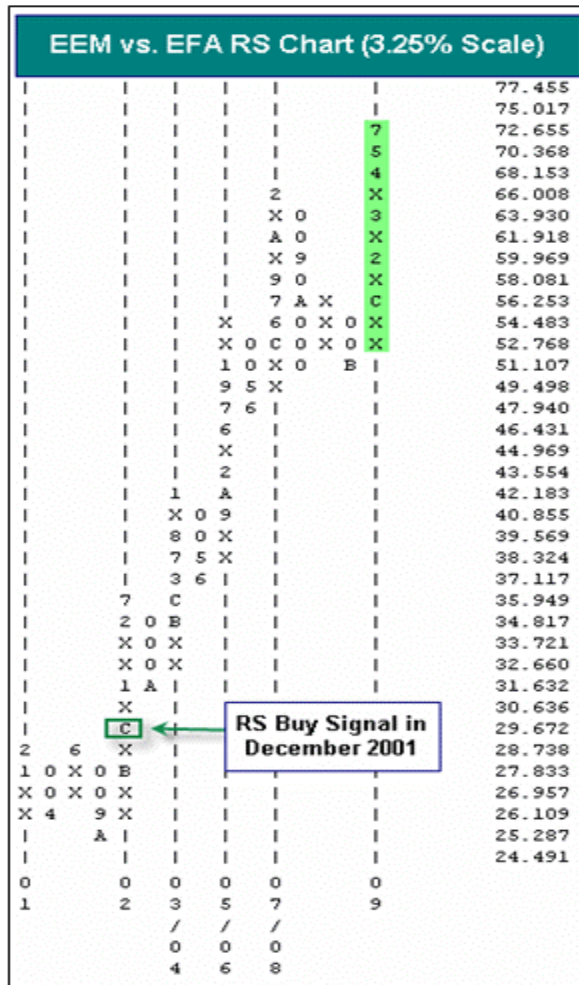
Emerging markets have gained a lot of market share from the developed economies since the year began. However, they still have a long way to go before the US's top position is threatened.

Source: Bespoke Investment Group

The BRIC nations combined are only 14% of the global market cap versus almost 44% for the US, UK and Japan. For comparison sake, in 1990, these big three were 75%, so the BRIC's have come a long way. However, given their size and good fiscal condition, they should have room to grow in the years ahead. To give you an idea of how a bubble looks, we can turn to Japan in 1990. After 30 years of torrid growth, this one country alone was over 40% of the world market cap. Yet, they took on too much debt and that led to a collapsing credit bubble. Twenty years and numerous bailouts later, they are only 7.7% of the world market cap. A decline of over 80%! We suspect that the decade ahead will continue to see a similar shift of assets away from the debt laden economies of the US and Europe into the emerging world. The chart below courtesy of the *Financial Times* shows that like two ships passing in the night, the US is now a smaller part of the global economy than the BRIC's. The global stock investors still appear to have some catching up to do in terms of capital allocation.



A question we ask ourselves is what signs to look for that can tell whether this emerging market economic momentum is stalling out or in the process of reversing. Relative strength analysis is a good tool to use in this regard. Below is a recent analysis from Dorsey Wright and Associates that give the decade that was from a relative strength perspective. Recall that relative strength is simply a way to measure the price relationship between two securities or asset classes. In this case, we are looking at the developed market index fund (EFA) versus the emerging market index fund (EEM).



Performance Since EEM RS Buy Signal

	12/06/2001 to 12/18/2009	
	\$ Change	% Change
EEM - iShares MSCI Emerging Markets Index	\$28.27	236.04%
EFA iShares MSCI EAFE Index Fund	\$14.69	36.72%
S&P 500	-\$71.02	-6.09%

Performance Since EEM RS Reversal to X's

	12/08/2008 to 12/18/2009	
	\$ Change	% Change
EEM - iShares MSCI Emerging Markets Index	\$16.27	67.85%
EFA iShares MSCI EAFE Index Fund	\$12.62	29.98%
S&P 500	\$186.38	20.49%

In December 2001, relative strength analysis told us that emerging markets had taken the batten from the developed world. Since that buy signal in December of 2001, the EEM is up 236% versus a 36.72% gain for the EFA. In addition, the chart shows demand still firmly in control. We will closely monitor this ahead to see if capital continues to flow in the direction of emerging markets.

In addition to relative strength analysis, money flow analysis does not seem to indicate any sort of bubble either. There was a big headline in the paper this week that emerging market mutual fund inflows from US investors surged to a record \$80 billion in 2009. Taken in isolation that seems like a big and impressive number. However, we decided to take a look back to the roaring 1990's to see what US investor inflows were into domestic US equity funds. As we suspected, \$80 billion is relatively not a very big number and does not indicate a bubble mentality. At the peak of the technology bubble, \$50 billion per month was flowing into US technology stock funds! Between 1996-2000, US investors threw \$1.1 trillion into US equity funds. For comparison, over the past five years net global inflows to emerging market funds have only amounted to \$140 billion. A bull market yes.....a bubble not likely yet.