

The BRICs phenomenon



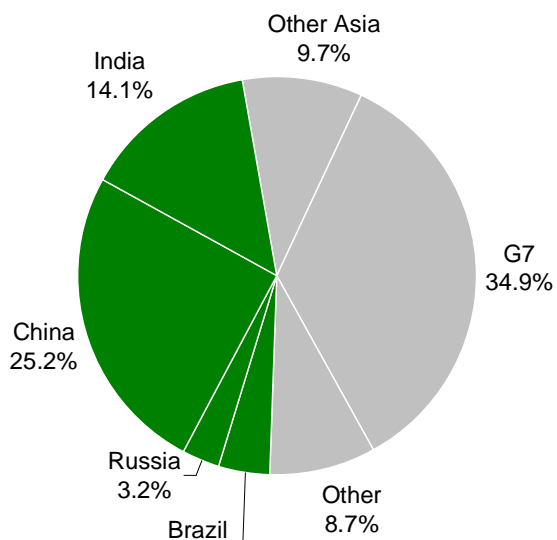
The four economies of Brazil, Russia, India, China are often referred to collectively by their initial letters – 'BRIC'. The term 'BRIC' was first coined by Jim O'Neill at Goldman Sachs in 2001 who argued that these countries had enormous economic potential and could become four of the most dominant economies in the world by 2050.

Having realised that the 'BRIC' economies offered great potential for investors, many pension funds, hedge funds and mutual funds have invested heavily in emerging market equity and debt funds. The 'BRIC' story is predominantly an Asian one, but the only Asian country in the JP Morgan EMBI+ is the Philippines which has a weight of less than 10% in the index. Latin America represents almost 60% of the EMBI+. Thus, investors allocating to emerging market debt have invested heavily in Latin America instead of investing in Asia. This is the exact opposite of the conclusion that the Goldman's analysis would suggest.

The world in 2050

According to Goldman Sachs, the world's largest economy in 2050 will be China which is expected to be almost 30% larger than the US, the world's second largest economy by then. However other Asian nations are more significant than Russia and Brazil combined.

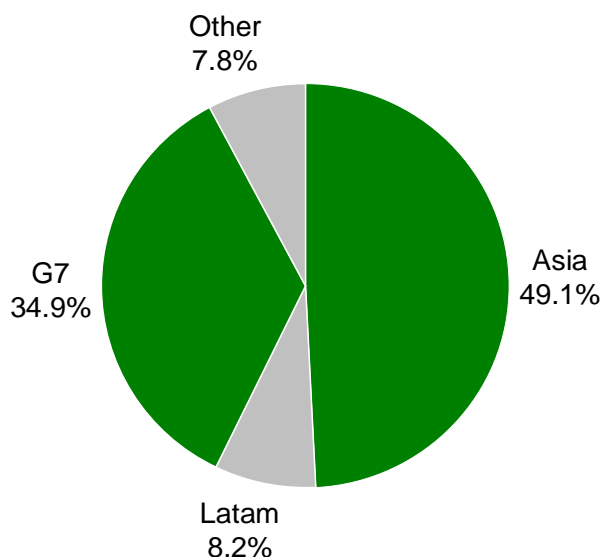
World's largest economies in 2050 by GDP



Source: Goldman Sachs

With Asia accounting for almost half of world GDP, by 2050, the BRIC's story is clearly an Asian story.

World's largest regions in 2050 by GDP

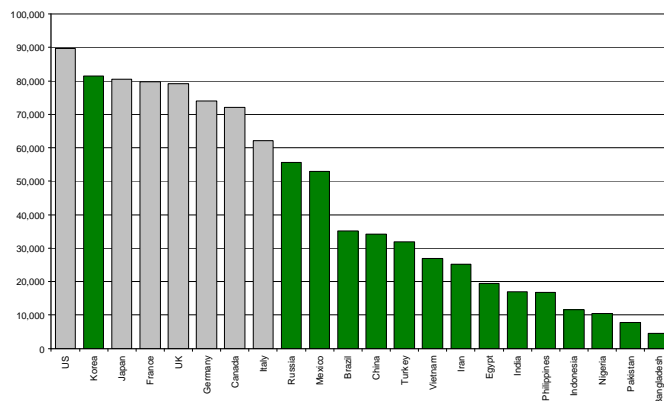


Source: Goldman Sachs

Korea, the missing K in BRIC

Just because a country is large does not necessarily make it a good place to invest. For bond investors, who are as concerned about default risk as they are about yield (at least they ought to be), the wealth of a country may be more important than its absolute size.

GDP per capita in 2050



Source: Goldman Sachs

When the largest economies are measured in terms of GDP per capita in 2050, Korea stands out as being the wealthiest of the economies in the Goldman's study, ranking second only behind the US. Korea is also the country which has by far the most rapid growth in GDP per capita over the period, with income per head rising from around \$17,000 per capita to \$81,000 per capita. As GDP per capita is strongly linked to credit ratings it is quite likely that Korea will be rated Aaa well before 2050. It is hard to see how a country which is expected to have such a dramatic increase in economic wealth over the next 45 years could be excluded from the list of dominant economies in 2050.

The world in 2015

Unfortunately with most bond markets not extending beyond thirty years, 2050 may be an unrealistic timeframe for bond investors to consider. Perhaps a 10 year time frame may be more reasonable. In ten year's time the world's largest economies outside of the G7 include Mexico and Korea, both of which are predicted to be larger than Brazil at that time. Other Asian economies in total exceed Brazil in terms of economic size.

Country / region	GDP	%
G7	34,488	68.49%
China	5,539	11.00%
Korea	1,845	3.66%
Russia	1,702	3.38%
India	1,680	3.34%
Other Asia	1,571	3.12%
Mexico	1,333	2.65%
Brazil	1,295	2.57%
Other	899	1.79%

Source: Goldman Sachs

As a whole, Asia is predicted to be 4 times as large as the countries of Latin America.

Wealthiest countries in 2015

Region	Country	2005	2015	Change
1 G7	United States	\$37,715	\$46,918	\$9,203
2 G7	Japan	\$39,853	\$46,859	\$7,007
3 Asia	Hong Kong	\$28,676	\$42,196	\$13,520
4 Asia	Singapore	\$23,772	\$32,117	\$8,344
5 Asia	South Korea	\$12,982	\$20,487	\$7,505
6 Latam	Argentina	\$7,699	\$9,902	\$2,203
7 Latam	Mexico	\$6,045	\$7,855	\$1,809
8 Europe	Poland	\$4,988	\$7,714	\$2,726
9 Asia	Malaysia	\$4,688	\$6,642	\$1,955
10 Latam	Venezuela	\$5,063	\$6,517	\$1,455
11 Latam	Panama	\$4,411	\$5,636	\$1,225
12 Europe	Turkey	\$3,442	\$4,959	\$1,517
13 Africa	South Africa	\$3,372	\$4,872	\$1,500
14 Latam	Brazil	\$3,620	\$4,702	\$1,082
15 Europe	Russia	\$2,430	\$3,965	\$1,535
16 Asia	Thailand	\$2,441	\$3,781	\$1,341
17 Europe	Bulgaria	\$2,148	\$3,350	\$1,202
18 Latam	Peru	\$2,282	\$3,069	\$787
19 Latam	Colombia	\$2,260	\$2,900	\$639
20 Asia	China	\$1,274	\$2,384	\$1,111
21 Africa	Egypt	\$1,552	\$1,995	\$443
22 Latam	Ecuador	\$1,475	\$1,881	\$406
23 Europe	Ukraine	\$989	\$1,668	\$679
24 Africa	Morocco	\$1,250	\$1,603	\$354
25 Asia	Philippines	\$1,077	\$1,353	\$276
26 Asia	Indonesia	\$771	\$1,133	\$362
27 Asia	Vietnam	\$532	\$927	\$395
28 Asia	India	\$575	\$912	\$338
29 Asia	Pakistan	\$561	\$711	\$150
30 Africa	Nigeria	\$430	\$552	\$122

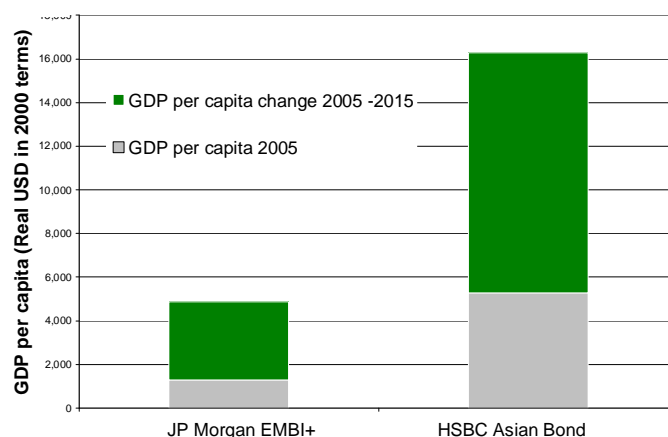
¹ Source: US Department of Agriculture, Economic Research, figures in 2000 USD

The Goldman's study only deals with the world's largest economies, not the wealthiest. To identify the world's wealthiest countries we used data from the USDA¹. Not every country in the world has debt which is tradeable, so we narrowed down our analysis to those countries which are constituents of the JP Morgan EMBI+ (EMBI+), the HSBC Asian Dollar Bond Index (ADBI), plus Japan and the US. The table shows that Hong Kong, Singapore and South Korea are the wealthiest countries with income per head approaching that of Japan and the US. Hong Kong is also the country which exhibits the greatest pickup in wealth over the next decade. The per capita incomes of countries in Latin America generally fall well below those of Asia. Together these 3 wealthy Asian nations, along with the giants of India and China, make up the Asian CHIKS (China, Hong Kong, India, Korea and Singapore)

Rich man, poor man, beggar man...

One of the considerations for investors when investing in debt markets is the repayment ability of the borrower. In an ideal world an investor would like to lend to a rich country at the same spread as a poor country. So how does Asia compare to other emerging markets? By weighting the GDP per capita incomes by the respective country weights in the ADBI and EMBI+, we can get a rough idea of the ability to repay for each group.

GDP per capita weighted by EMBI+ and ADBI



¹ Source: US Department of Agriculture, Economic Research

As the chart shows, Asia's income per head is both higher in absolute terms, and in terms of expected growth (weighted according to their index weightings). As a result we would expect upgrades in the Asian bond index to be far higher than in the EMBI+. Despite this fact there is very little difference in spread between the two indices.

	Spread	Yield
HSBC Asian Bond Index	153	6.09
JP Morgan EMBI+	206	6.75

Source: Bloomberg as of 3rd October 2006

Any investor who currently holds emerging market debt, and who believes in the Asian CHIKS story, should switch into Asian fixed income as relative ratings shifts are liable to create higher total returns from holding Asian fixed income rather than emerging market debt.

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