Thailand: New Elections and New Promise

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It was only last year that the Red Shirt protesters - a populist movement of supporters of billionaire former prime minister Thaksin Shinawatra - were dying by the score in the streets, gunned down during an army crackdown on protesters that left ninety of them dead. The Red Shirts came roaring back on July 3rd, however, scoring a landslide victory for their candidates, securing the majority of the seats in Parliament, and installing Yingluck Shinawatra, the sister of the deposed billionaire, as Thailand's first woman prime minister.

The election is seen by some as a triumph over corruption and cronyism, while by others as the result of crass populist vote-buying: The Red Shirts ran on a platform of a 40 percent increase in the minimum wage - currently 300 Baht per day, or just under $10 - and free computers for schoolchildren. It is both. The outgoing government was riddled with corruption and graft, though Shinawatra's brother's regime had severe corruption issues of its own.

Recovery from the Asian Crisis

Thailand has come a long way since the Asian currency crisis of 1997. Back then, nearly every financial institution in the country imploded in a matter of days, sparking a mass migration of hundreds of thousands of workers from factories and financial institutions in Bangkok back to their farming villages. Fast forward a decade, to 2008 - and an even more severe global crisis - and the Thai financial sector hardly broke a sweat. Not a single bank fell. And while the Thai economy did contract 2.2 percent during the year - mostly the result of declining exports to countries more severely affected - Thailand's economy has demonstrated remarkable resilience, and continues on a solid growth trajectory.

Recent Market Performance

Overall, Thai stocks returned 63 percent in 2009 and another 40 percent in 2010, fueled by a recovery in exports. The Thai Baht also appreciated about 14 percent against the dollar in that same period, juicing returns still further for U.S. investors who do not hedge away currency risk. So far in 2011, the Thai stock market has returned 8.4 percent.

Trends

A number of factors suggest a favorable investment environment in Thailand. First, valuations are quite reasonable: Thai equities are trading at a P/E ratio of

around 12 times earnings, while earnings growth continues to rip right along at between 15 and 20 percent. Meanwhile, Thai stocks are generating a dividend yield of around 4 percent - which makes them extremely attractive when compared to the anemic returns forecasted in western markets.

Second, the financial sector is on a firm footing, anchoring the rest of the economy. Default rates are low, but banks have been able to grow their loan base as private investors find profitable ways to invest their borrowed capital. The solid financial sector fundamentals are undergirded by a high savings rate and low debt-to-income ratios across the board. The emerging Thai middle class is unlikely to get in over its head.

Third, Thailand looks like it will be the beneficiary of continued growth in China. The Chinese government opened up a free trade area with the ASEAN bloc at the beginning of 2010, and continues to invest in road and rail network infrastructure to grease the flow of Thai raw materials and low-end manufactured goods into the country. It appears that China has been successful in moderating its growth to a sustainable level while avoiding a crash. As long as China's economy continues to expand, it will pull Thailand along, since Thailand helps fulfill China's insatiable demand for products like rubber, tungsten and even electrical components.

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Commodity prices have also been on the rise, which particularly benefits Thailand's rural communities, and tends, in the aggregate, to support a Thai middle class. Thailand's extremely low 1.5 percent unemployment rate suggests that the middle class is in good shape, and wages have some room to rise, which will fuel domestic demand for consumer goods and allow Thai retailers to continue to gain traction.

Thailand is also enjoying success at attracting business from Japanese manufacturers, looking to outsource the manufacture of smaller components. Thailand's free market economy and combination of productive labor at a reasonable price makes them an attractive labor market for Japanese outsourcers.

On a more somber note, the recent tsunami in Japan has provided a boost to Thai exports, as Thai agribusiness picks up the slack for a good deal of farmland and other agricultural assets that were destroyed in the disaster. Thailand is

exporting an increased amount of rice and other foodstuffs to Japan.

Risks

Thailand is heavily dependent on exports, which represent more than half of its GDP at present. As such, Thailand's economy is sensitive to the ebbs and flows of foreign demand, particularly in the United States. A double-dip recession in the U.S. will adversely affect the fortunes of Thai manufacturers and their laborers, though the strength of the middle class is beginning to mitigate against that possibility and enable the Thai economy to diversify.

Where there was reason for worry about political instability as recently as last year, the recent election results go a long way to mitigate that concern: With their overwhelming victory in Parliament, the Red Shirts clearly have the support of the people - for now. There is no reason for them to resort to violence. The outgoing government is not contesting their right to form a new government, and the army is not likely to intervene to attempt to overturn the clear results of a popular election.

The Red Shirts' intention to raise the Thai minimum wage by 40 percent could have a negative effect on the fortunes of Thai manufacturers. But with an extremely tight labor market of 1.5 percent unemployment, competition for scarce labor has an even greater effect on wages than minimum wage laws. If the government is successful at spreading the benefits of Thai economic progress to the countryside, increasing the lower-end wages of Thai workers, however, this could be a boon to businesses that cater to domestic consumer spending, such as retailers. Middle class growth and reduced poverty in rural areas is good for business, in the long run, and a stabilizing influence.

Strategy

The fund management team at Thai Capital is setting their sails for growth. Despite ongoing weakness in the U.S. economy, they are betting on the resilience of the Thai economy and the solid foundation of Thailand's banking and finance sector. Currently, the fund's biggest exposures are in the energy sector (23.39 percent), banks (17.64 percent), and petrochemicals (13.89 percent). Going forward, the portfolio managers believe the Thai economy should grow at a four to five percent clip next year, but earnings growth should continue to be between 15 and 20 percent. The fund is currently trading toward the low end of its 52 week range. More importantly, fund shares are trading at a 12 percent discount to the fund's net asset value - a bonus for any fund investing in a dividend-paying market, since dividend and earnings yields are based on net asset values, not discounted closed-end fund prices.

Thai Capital's Role in a Portfolio

The Thai Capital fund does not appear to be inordinately risky, compared to other emerging market equity funds, thanks to the solid footing of the financial sector, the reasonable valuations and substantial dividend yield. Consider this fund for a value-conscious exposure to the Thai economy, to the energy sector, and, in an indirect way, to the fortunes of the Chinese economy. ■

Chinese Banks: At the Crossroads

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The subject of Chinese banks has been much in the news of late. China bulls point to the compelling long-term advantages of the Chinese investment environment, compared to the west: Modest debt levels, a strong savings and investment rate, an emerging middle class and favorable demographics, courtesy of a relatively young population.

China bears, on the other hand, point out that China's banks are shoring up their capital positions for a reason. A long history of totalitarianism doesn't die easy, and Chinese banks have made a lot of loans to questionable local entities at the behest of Beijing. Chinese banks, therefore, may be understating their underperforming loans substantially.

As if to underscore the bearish take, Fitch has been rattling its sabre at the Chinese, changing their AA-rating outlook from neutral to negative this spring, and warning the Chinese to make some changes.

We're not overly concerned at

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this point: The ratings agencies have been in a foul mood lately, and have been rattling their saber in every direction-not surprising in an increasingly global and interconnected marketplace.

The Big Picture

China has a long-term secular tailwind that will continue to favor capital formation in the country for a long time to come, according to Agnes Deng, portfolio manager for The Greater China Fund (GCH), a closed-end mutual fund that focuses on equities in China, Hong Kong and Taiwan. The basis for her optimism: China's savings rate, which at 56 percent, dwarfs the paltry 11 percent figure posted by the United States. Investments as a percentage of GDP confirm the picture sketched by the savings rate figures: China invests 54 percent of its GDP each year; the United States just 15 percent, according to Alison DuPont of Aberdeen Asset Management.

Meanwhile, the profits from U.S. consumption are increasingly flowing to Chinese workers - fueling the rise of a powerful Chinese middle class, even as America hemorrhages manufacturing jobs. Consider:

China is now at once the largest market for consumer cars in the world; and the largest car manufacturer. China is also the world's biggest cell phone market and manufacturer. You can't shut that off for a net creditor nation. There are no creditors to take away the punchbowl.

Furthermore, long term trends tend to favor the continued flow of capital to Chinese projects, away from the west. The combination of a weakening dollar, continued deficit spending in the U.S. and elsewhere in the West, and comparatively modest returns should have investors taking their capital and going east.

Fundamentals

Yes, China appears to have overexpanded in certain sectors. For example, Chinese municipalities routinely formed local government financing vehicles, or LGFVs, to act as conduits for borrowing and building Chinese infrastructure. And some of these LGFVs are having trouble, as municipalities are getting slow to pay off on loans from Chinese banks. Beijing, already smelling trouble, acted prudently, requiring banks to raise reserve ratios to a record 21.5 percent. Chinese banks also increased default coverage ratios from 80 percent to 220 percent, when measured by loans the banks themselves have defined as in trouble. Some observers, however, feel that the 3.5 percent publicly recognized default rate is unrealistically low, and it's just a matter of time before the sweet and sour chicken comes home to roost.

Meanwhile, Deng is still seeing favorable valuations in China, across

a variety of sectors. While she notes that Chinese equity prices have benefited from recent multiple expansion, there are still some good values, particularly in domestic consumer spaces benefiting from the rise of the Chinese middle class, such as retail and health care stocks.

Cash Counts

For investors, however, the primary focus is on the publicly traded banks, which are comparatively insulated from the trouble that may be accumulating for smaller banks. The banks that comprise the financial component of the Hang Seng index tend to have better ability to raise liquidity in a pinch than their smaller cohorts. Sanford C. Bernstein & Co. estimates that the large publicly-traded Chinese banks have capital reserves sufficient to cover about a 27 percent default rate on these local government loans, if need be, and still weather the storm. Standard & Poor's is anticipating perhaps a 20 to 30 percent eventual default. Which means the worst case would involve about a 3 percent shortfall.

But remember: The Chinese government is the world's biggest creditor nation, and the world's biggest holder of cash reserves. Cash counts, and the Chinese have plenty of it. If need be, the Chinese government has the wherewithal to intervene, make up the shortfall and keep these banks running without batting an eye. Where the U.S. had to borrow hundreds of billions to execute TARP, the Chinese government's substantial reserves and stores of surplus capital could absorb the shortfall with relative ease, if it chose to intervene.

Due Diligence is Key

Western investors are spoiled in one sense: Many of us are quite accustomed to having a government willing and able to act as a watchdog, protecting the interests of investors, and taking much of the burden of due diligence off the backs of the investor. Things are very different in much of Asia, DuPont asserts. Yes, China has demonstrated a willingness to enforce laws against fraud, and have prosecuted some high-profile cases. But the Chinese marketplace is much more opaque, and caveat emptor is the watchword of the day. This environment, of course, favors the skilled fundamentalist, bottom-up stockpicker over the unskilled regional indexer. Controls are better in Hong Kong, for example, than the rest of China, thanks to a strong shareholder culture. Active managers are able to concentrate in these more favorable environments, while still maintaining better diversification than indexers. This is one environment where a skilled active manager can earn her keep, seeking compelling growth and long term value while sidestepping risks. ■