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Intelligent Money

Current thinking from Haven Financial Advisors

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Special Notes of Interest:

2007 has been a good for IPOs. Through November, new share issues have raised $255 billion against $246 billion over the comparable period last year.

Foreign buyers account for a large fraction of US treasury debt – about 32%.

Emerging Economies Recycle Dollars

Sovereign wealth funds have emerged as one of the new pillars in the global economic system. They have been around since the 1950s but have only recently expanded with the rise of global trade imbalances. Countries generate investable funds by running a current account surplus and thereby accumulating foreign exchange reserves. Sovereign funds manage those "extra" resources. Already they have accumulated more cash than the hedge fund industry.

Collectively, they control about $3 trillion and are expected to invest another $5 trillion in the next 5 years. To put things in perspective, the overall size of world's equity markets is about $33 trillion with bond markets adding another $67 trillion. Sovereign funds are a significant, if not a decisive, player in capital markets.

Currently, more than 20 countries have these funds with the top five accounting for about 70 percent of total assets. Most are raw materials exporters. Middle Eastern and East Asian countries are among the biggest players. Russia, Norway, Alaska, and Canada are other examples – all coincidentally have large energy reserves.

Saudi Arabia plans to establish a sovereign wealth fund that should dwarf Abu Dhabi's $900bn and become the largest in the world. Until recently, most of Saudi's foreign exchange reserves were reinvested in western bond markets – so this is a signal announcement. The foray into equity investment is echoed by other funds and is intended to enhance the yield on a large pool of cash.

To date, western governments have not imposed legislative or regulatory barriers to the investments of sovereign wealth funds. American and British policy has focused on disclosure and openness in the operation of these sovereign funds. Of course, reciprocity of market access remains a key negotiating point. Even now, China and the US have accelerated talks on a bilateral investment framework to streamline the investment process into one another's home markets. China's concerns date from the failed 2005 purchase by CNOOC, the state energy company, of Unocal, a US oil and gas company. China has agreed to lift a moratorium on foreign entry to its securities industry but has yet to offer details beyond allowing underwriting of new shares.

Sovereign wealth funds distinguish themselves from hedge funds in that they typically avoid leverage and tend to invest for the long term. They don't short stocks or currencies either. As such , it is thought that they tend to stabilize markets – The European Central Bank said so on the record in December. Most recently, they have taken equity positions in a market sector begging for a capital infusion – banking. The subprime lending crisis has put western banks in a tailspin. To date, they have written down over $60 billion in securities as the underlying collateral has deteriorated. More write downs are likely to follow - perhaps $200 to $300 billion.

Since May 2007, SWFs have made at least 15 large investments in banks and financial institutions worldwide, totaling more than $40 billion. In fact, the list of high profile investments in western investment banks reads like a who's who list. Coincidentally, all have written down significant assets within the last 5 months.

Fund	*State*	*Target*	*$ Billion*	*% Stake*
Temasek	Singapore	Merrill Lynch	4.4	NA
Singapore Investment Corp. (GIC)	Singapore	UBS	9.7	9.0%
China Investment Corporation	China	Morgan Stanley	5.0	9.9%
Abu Dhabi Investment Authority	Abu Dhabi	Citicorp	7.5	4.9%
Citic Securities	China	Bear Stearns	1.0	6.0%
China Development Bank	China	Barclays PLC	3.2	3.10%

Politicians in the US and Europe might once have been opposed to these investments. Now they are happy for recycled third world dollars to shore up critical financial institutions. Some analysts call the phenomenon the "Sovereign Wealth Fund Put" as third world capital effectively has placed a floor on the price of key financial assets. Just a

year ago, the buzzword was “private equity put” as private capital and hedge funds were swooping in to prop up underpriced assets.

There have been other strategic acquisitions. In October, China’s sovereign wealth fund invested $3 billion for an equity stake in the elite hedge fund, the Blackstone Group. Dubai International Capital has invested about $500 million in Sony Corp. Within a few years, sovereign interests should have significant stakes in a wide swath of western businesses.

Indeed, one of largest targets of China’s exchange reserves are its own banks. Beijing said on Monday that a unit of its new $200bn sovereign wealth fund would inject $20bn into China Development Bank in a move intended to smooth the policy lender's transformation into a commercially-oriented institution. Only about 30% of the fund’s cash is earmarked for foreign projects – the rest is intended to shore up domestic finance and industry.

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As SWFs shift emphasis from placing money with outside managers to managing it themselves, they are actively seeking top level executives. Alan Greenspan has been approached by the Chinese to join the international advisory board of the China Investment Corporation. They are even using the same headhunters that find talent for private equity funds. So far, they have only tapped mid level talent as the pay packages do not yetapproach those of hedge funds and private equity.

SWFs are not the only indicator of wealth in the world’s emerging economies. Initial public offerings are another example. While developed market IPOs faltered in the second half of 2007, emerging market IPOs accelerated. In terms of capital raised, 14 of the top 20 IPOs were from emerging markets. The 2nd biggest IPO was China Citic Bank, which raised almost $6 billion in April in a joint listing on the Shanghai and Hong Kong exchanges.

Emerging market companies, often considered “national champions”, are playing a greater role on the economic stage. Five of the world’s ten largest companies are Chinese and Russia’s Gazprom is also on that short list. A more transparent financial system and growing liquidity at home are stimulating domestic consumption in the third world.

The performance of emerging market assets indicates strong fundamentals. The FTSE Emerging Market Equity Index was up 36.7% in 2007 and nearly 15% annually over the past ten years. In fact, emerging market equities now comprise just under one tenth of the world’s market capitalization.

Emerging market sovereign bonds are trading at historically tight spreads to US treasuries – trading only 2.4% higher at years end. 3rd party credit ratings for both sovereign and corporate debt have improved substantially over the last few years.

We can expect ever greater integration of developed and emerging economies as third world economies recycle their surpluses as equity investments. In the short run, these investors are likely to be passive. However, as they accumulate investment expertise, real partnership may emerge.

The Global Bond Market

“Within a few years, sovereign interests should have significant stakes in a wide swath of western businesses..”

Historically, American investors have invested solely in domestic bonds for their fixed income asset allocation. Evolving foreign markets are forcing investors to rethink this strategy. The aggregate bond market outside the US is larger in absolute terms. The market for government bonds in Europe has eclipsed our own treasury market since the adoption of the Euro. This is a strong money denomination gaining market share as a reserve currency.

There are now considerable bond markets outside the developed world – almost $6 trillion with much now denominated in local currency. The fast area of growth has been in the corporate market as sovereign demand has attenuated. Emerging market don’t need the money as trade surpluses provide ready reserves. In fact, nearly 40% of emerging market debt is investment grade while almost none enjoyed that rating in the mid 1990s.

The sheer size of foreign debt markets invites investor participation. By spreading fixed-income investments among the bonds of countries at different stages of the economic and interest rate cycle, investors can potentially reduce overall risk and portfolio volatility relative to a portfolio of domestic bonds. In the past, the world caught a cold if the US sneezed. Evidence from the past several months suggests that emerging market growth is sustainable even in the face of slowdown in the US. All the more reason to participate in these uncorrelated markets.

The falling dollar has focused investor attention on foreign markets. PIMCO has offered a number of foreign bond funds for years – some hedge the currency risk while some do not. Just this past October, State Street Global Advisors brought to market an ETF that focuses on the sovereign bonds of foreign countries. More are likely to follow and, with competition, costs will decline. We currently use all these products.