



Adviser Soapbox

## Hedging Asia: China Versus India

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The imposition and subsequent removal of capital controls in Thailand last week was a stark reminder of the risks inherent to investing in emerging markets. The episode illustrated the importance of understanding the global macro picture associated with international equity positions. (Thai closed-end funds include the Thai Fund and the Thai Capital Fund. The one-day 14% decline in Thai stocks (and subsequent 11% recovery the following day) demonstrated the significance of foreign investment flows in emerging market equities, especially in today's liquidity-driven investment environment.

### India

India has been one of the biggest beneficiaries of foreign investment flows, receiving an estimated 25% of total portfolio flows into emerging markets. According to Morgan Stanley, in the three years through 2005, non-foreign direct investment flows accounted for 83% of total capital flows in India, compared with an average of only 32% for a basket of other top emerging markets, including Russia, Mexico, Turkey and China. This is a staggering piece of data, because unlike Foreign Direct Investment flows, portfolio flows can--and often do--reverse suddenly and without warning. Liquidating a factory that one has built in India cannot be accomplished overnight, but all it takes for an investor to liquidate Indian stocks is a few clicks of the mouse.

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The amount of portfolio investment capital flowing into India spiked sharply higher in 2003 and contributed to a virtuous circle--higher capital flows into India resulted in an appreciating currency, the stronger currency helped push down real interest rates, lower interest rates encouraged rising borrowing, increased borrowing resulted in strong credit-driven economic growth, and strong economic growth encouraged even more capital to come into India.

This kind of positive macroeconomic feedback loop works fine until something happens to break the cycle. And investors were given a preview of what that might look like this past summer, when India suffered huge equity outflows in May and June. This sudden reversal in portfolio flows hammered Indian stocks, with the SENSEX index plummeting 29% before bottoming on June 14.

India's SENSEX stock index, like just about every other major global equity index, has since recovered to make new highs, and net investments by foreign institutional investors in Indian equity markets rose to a record high \$2.04 billion USD in November. But if the past three years is any guide, the recent sharp increase in portfolio fund flows may mean that Indian stocks are once again highly vulnerable to a correction. Whenever portfolio flows reached similar levels in the past three years, Indian stocks experienced a sharp correction not long thereafter.

### India's Worsening Macroeconomic Fundamentals

The macro picture in India is looking increasingly troubling. India's current account deficit almost doubled to \$10.6 billion USD in the fiscal year ending March 31 and is likely to widen in 2007-08. Despite higher interest rates, the pace of bank lending has remained stubbornly high; India's bank lending growth has averaged nearly 30% per year since 2004, running well in excess of deposit growth and pushing the loan-to-deposit ratio to record levels. Housing loan growth is currently running at a rate above 50% over the previous year, and commercial real estate loan growth has surged 102% over year-ago levels causing real estate prices to soar, with properties in the primary metropolitan areas of India having jumped as much as 300% in the past three

years.

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Signs of excess in the economy are starting to worry the Reserve Bank of India (RBI), which jolted the markets earlier this month with an unexpected increase in the Cash Reserve Ratio (CRR) of 50 basis points, causing a three-day decline of 7% in Indian stocks. There are also concerns that the rapidly rising wages being reported by some Indian companies may spill over into the broader inflation measures.

India thus faces a dangerous double-edged sword--strong foreign capital inflows have contributed to the RBI's growing concerns about excess liquidity in the system, but without these capital inflows from abroad, India's current account deficit would become unmanageable.

In the very near term, we are unwilling to bet against the wave of momentum that propelled almost all emerging-market equity markets to big double-digit gains in 2006. But after three years of uncommonly strong portfolio inflows, record-high equity valuations and a tightening global liquidity environment, a short position in Indian equities combined with a long position in a better-positioned emerging market seems like a nice risk/reward trade. Chinese equities look like a good candidate for the long side of this trade.

### **China: A Very Different Story**

Unlike India, China posted its second-largest trade surplus ever in November and will see its full-year trade surplus swell 65% to a record US\$168 billion in 2006 from \$US102 billion in 2005. China also benefits from a very high national savings rate of approximately 40% of GDP versus 25% for India. And, unlike India, where the central bank is becoming increasingly concerned about excesses in bank lending and real estate prices, China has experienced an orderly moderation in sectors like construction that policymakers tend to view as worrying.

What is more, U.S. policy makers continue to pressure China to let the renminbi rise against the dollar. Barring any misguided efforts by U.S. lawmakers to force an extreme currency revaluation with tariffs or some other kind of anti-China protectionist legislation, the macroeconomic and political factors exerting upward pressure on the renminbi should be a net positive for Chinese securities.

The positive macro outlook in China means that the Chinese markets should be better insulated from any sustained reversal in global portfolio fund flows making the Chinese/Indian equity pair attractive.

We also see less reason to worry that the rally in Chinese equities has already run its course because strength in Chinese stocks has been a more recent phenomenon. While India and most other emerging markets made big gains in 2004 and 2005, Chinese stocks did next to nothing. Yet beginning in December 2005, Chinese stocks began to outperform. Now, as we approach the end of the year, India's SENSEX index is up more than 45% (Indian closed-end funds include the India Investment Fund and The India Fund, and there is also the newly issued exchange traded note), but the HSCEI index of Chinese stocks has soared more than 70% (components of this index that trade in the U.S. as ADRs include PetroChina Huaneng Power and China Life). It is also significant that domestically traded Chinese shares, which fell more than 20% from March 2003 through the end of 2005, are up more than 100% year-to-date. This suggests to us that the recent outperformance of Chinese stocks has become a broad-based phenomenon supported by domestic investors. The 2008 Beijing Olympic games should add another driver for increased investment next year.

The investment conclusion seems clear to us: Between Asia's two fast growing giants, China is the buy and India is the sell.

[Excerpted from the December issue of Inside Global Markets, which includes expanded analysis. Click here for more information about \*Inside Global Markets\* subscription details.](#)

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