

How to Invest in China...by Investing in Other Markets

Emerging markets portfolio manager Claudio Brocado explains how investors can participate in the booming Chinese economy by investing in other developing markets.

The eyes of the world are on China, whose powerful growth is a major force in the global economy. China's huge demand for energy, metals and other commodities to support manufacturing and infrastructure development has benefited companies in other emerging markets—and created attractive equity opportunities for knowledgeable investors.

For these investors, participating in Chinese growth does not have to mean overweighting Chinese stocks, whose valuations, while not historically high, are relatively expensive. Instead, they are seeking companies that benefit from Chinese growth, in Brazil, Russia and other markets, where they can find similar growth potential at cheaper prices.

Opportunities in the Materials Sector

Steel manufacturing in China has been rapidly expanding to feed the country's booming housing and infrastructure build-out. As the world's largest buyer of iron ore—the primary raw material for steel production—China drives the global market, boosting companies such as Brazilian mining giant Vale de Rio Doce as well as Bradespar, which holds a key stake in Vale. During fourth quarter 2009, Vale derived 44% of its iron ore sales from China.

Production volumes and prices for iron ore are expected to jump in 2010 and beyond. Increasing demand for automobiles in both China and Brazil, along with ongoing restocking by auto industry suppliers, should benefit iron ore providers for several more years as worldwide steel manufacturing spikes up. The recovery in global steel demand bodes well for steelmakers in countries such as Russia and South Korea.

China also uses more copper than other nations, with approximately 38% of global market share. In addition to buying the metal for massive infrastructure development, China requires enormous amounts of copper as it seeks to bring annual production of electric and hybrid cars to 500,000 by the end of next year. Only 2,100 such vehicles were produced in China during 2008. Considered perhaps the most sought-after metal, copper has soared in price over the past year, improving earnings growth estimates for copper producers in Poland, Mexico and other emerging countries, where valuations are generally lower than those in China.

Russian Energy and More

Russia, in particular, benefits from rising energy prices resulting from soaring Chinese demand. For example, the country will begin shipping crude oil directly to China next year via a newly built pipeline as part of a 20-year energy pact. For investors, Russian companies can offer advantages over Asian providers, which tend to be downstream or integrated oil producers that must buy part of the crude they process. When oil prices climb faster than the price of their refined products, their profit margins can suffer. Moreover, Asian energy companies often trade at substantially higher valuations than their Russian counterparts.

Non-energy related companies in Russia can also be energy plays. In contrast to other energy-rich countries, Russia's overall equity market is highly leveraged to global energy prices, with stocks in industries ranging from banking to telecommunications often displaying higher correlations to oil price movements than dedicated Chinese energy companies. As a result, many Russian companies tend to respond well to stable or rising oil prices. Thus an overweight in non-energy, Russia-based stocks can more than compensate for a seemingly large underweight in stocks that are strictly related to energy.

The Power of Bottom-Up Fundamentals

At Batterymarch, we believe that the best way to capitalize on China's robust economic growth is from the bottom up, focusing on individual companies with strong fundamentals. The most attractive companies score favorably across a variety of fundamental measures, with superior longer-term growth prospects and reasonable valuations.

In today's emerging markets environment, underlying stock fundamentals point to underweight positions in the Chinese market and the developing-market energy sector—two areas with significant growth potential but relatively expensive share prices. However, they also point to overweights in materials and Russia. These indirect plays on the Chinese economy and higher energy prices allow investors to participate in outstanding growth opportunities without overpaying for the privilege.

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