SIDE – NOTE

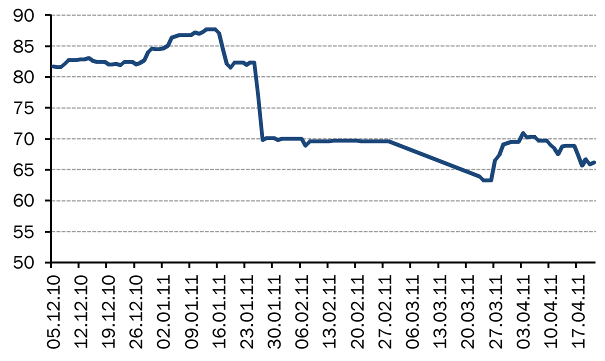
Does MENA-crisis point to time-series fundamental changes?

(Reshaping investors' sentiments within autocratic countries)

In our side-note *"Positive view on power centralization scenario,"* we described a hypothesis under which, thus far, capital flows did not fully discriminate between democracies and autocracies. We assume that most investors rarely asked whether investing in pro-authoritarian countries, such as Kazakhstan, China or Egypt, was riskier than investing in pro-democratic Brazil, India or Turkey, with political risks like those common to EM regional features. Moreover, autocracies were considered guarantors of stability. However, with the ongoing MENA-crisis, such attitudes may be on the wane, reflected in our intensive concern for monitoring authoritarian countries' credit spreads.

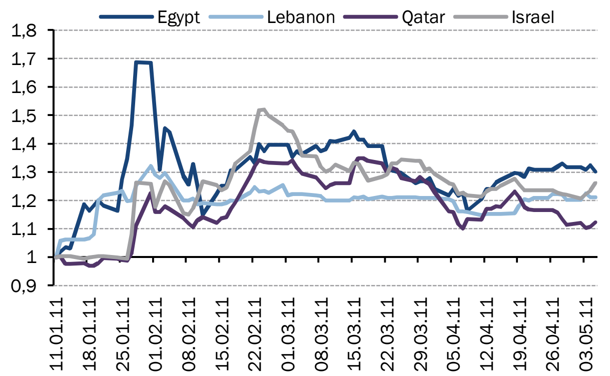
Ongoing Arab revolutions have triggered a waterfall of events that sharpened the attention paid by both portfolio and direct investors to non-quantifiable risks; in particular geopolitical, political and societal risks. The short-term investment implications of the turmoil include broad re-pricing of risk across the entire region. Sovereign CDS spreads have widened and stock markets have declined, most notably in Egypt, which has the largest stock market cap in the Arab world.

Egypt Exchange Market Capitalization (USD bn)



Source: Bloomberg

Sovereign CDS dynamics of some African and Asian countries

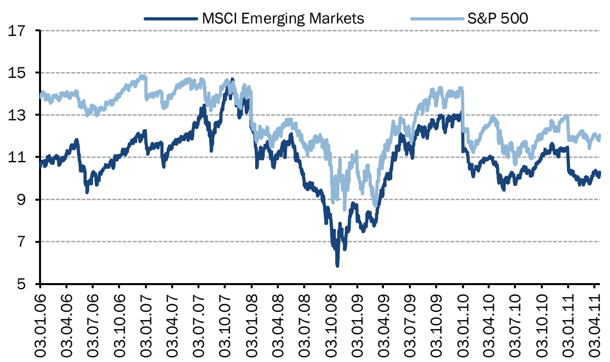


Source: Bloomberg

Notes: normalized graph (data as of 01/11/2011 = 1)

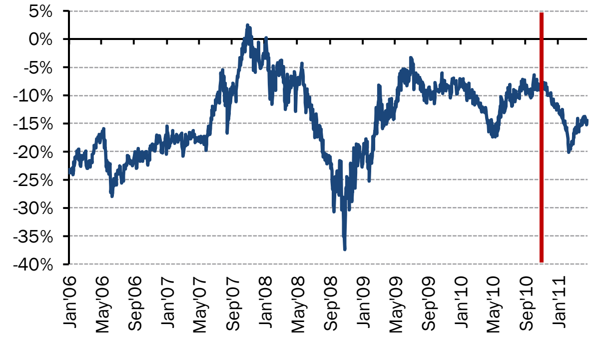
More broadly and in the longer term, the general implication for investors of the Arabian events is the following: they are dealing with non-quantifiable risks, like the "black swan". In particular, a risk is quantifiable and characterized by a measure of randomness with knowable odds. On the contrary, non-quantifiable risks are unpredictable. Investors need to consider the social features of various systems, with no prudential way to measure the development of a given situation in hard numbers. This makes investors "uncomfortable," as they are not adept at dealing with uncertainties. As a consequence, the discount at which autocratic EM traded over 2010, compared to the developed, is beginning to rise. It may be evidence of fundamental change in time-series. We will, thus, take into account this tendency towards movement in our future investigation of the correlation between political regimes and sovereign spreads.

Egypt Exchange Market Capitalization (USD bn)



Source: Bloomberg

Premium/(discount) of emerging market equities



Source: Bloomberg, AYA calculations

Notes: based on P/E NextYr ratio of MSCI EM and S&P 500

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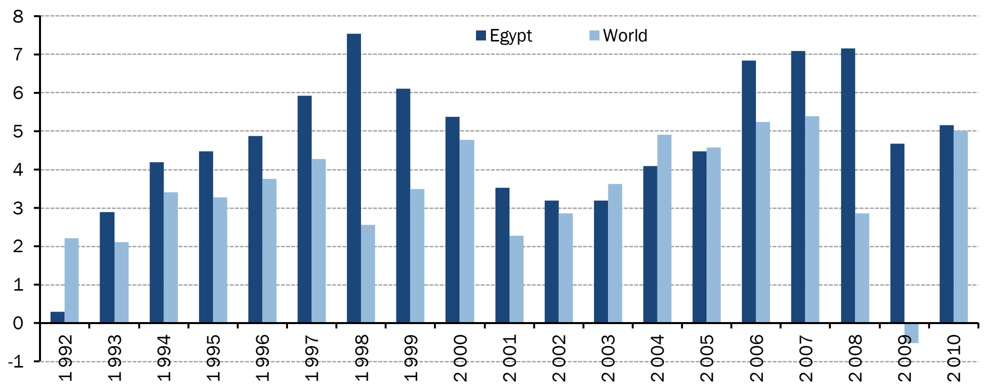
When the political future of a country or a particular system is uncertain, it is normal for investors to apply a discount to the value of assets located in these countries or political regimes. However, at the end of 2010, this discount was almost non–existent (in some cases, EM even traded at a premium). The discount shrunk to 3% in emerging markets as a whole, whereas only while 5 years ago they were valued – on average – at a 25% discount versus developed markets (35% 10 years ago). This suggests that emerging markets present, in the eyes of investors, risks that are just above those of high–income countries.

This finding remains under our close attention, because EM spreads may widen and optimistic valuations may taper off in the event of investors assuming autocracies to be more vulnerable to abrupt changes of power. This is not to say that democracies are naturally resistant to social unrest; however, no democracy can fall victim to a wave of democratization. Furthermore, we will pay close attention to a possible shift in investors’ choices of high–growth countries. The most obvious lesson from Tunisia and Egypt is that rapid economic growth does not buy political stability. Rapid economic growth may do just the opposite – generate political unrest, as social expectations increase in conjunction with wealth.

Real GDP growth: Egypt vs World



Source: Bloomberg

At present, a combination of resent change in the US rating, inflation fears and MENA unrest is pushing down EM equities across the board. This makes it difficult to isolate the specific effect that political risk is exerting upon EM in general. It is also partially compensated by excess liquidity, which is exerts a direct impact on emerging markets in the search for extra yields. Thus, in the coming months, we will be closely monitoring:

1. whether the discount between EM and developed countries will grow again;
2. whether non–economic risks (societal, political and environmental) become more prevalent in EM, than they are in developed markets;
3. whether investors will come to discriminate more between full-fledged and “managed” democracies.

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