RISKS, RIOTS AND REWARDS

Diverse challenges, many of them unexpected, could slow Asia's inexorable rise. Investors need to be wary, well informed and unafraid.

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Risk is back. The more prudent of you might say it never went away! But I would argue that the events that began in 2007–08 have fundamentally shifted investor expectations, as we have been assaulted by four system-shaking credit crises. We are not the men or women we were.

Gillian Tett in the *Financial Times* recently offered this four-step typology, which I rather like:

- First, we faced a credit risk when a part of the American domestic mortgage market went into default.

- Second, a liquidity crisis was brought on by counter-party risk. The fall of Lehman Brothers was its most visible manifestation, along with the rescue of AIG, but inside the crisis the fact that the wheels seemed about to come off the capital markets was more mundane but perhaps more frightening. We all remember the last months of 2008 and early 2009 when a simple letter of credit for routine trade exports became almost unobtainable. As Prime Minister Gordon Brown's envoy for the G-20 at the time, I remember the scramble to get some official money behind the world's oldest, and until then most routine, international financial transaction. World trade plummeted 20%. In a globalized world, we feared, if trade stops, the world stops.

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- Third: Last year investors saw their safe haven, sovereign debt, buffeted by weakness in the eurozone. This year, that credit crisis continues to play itself out as so-called rescue packages still avoid addressing the real sustainability of the public finances in Greece or Ireland or Portugal or even U.S. municipal finances. The recent *Economist* cover spoofing fictitious U.S. state names, such as Califoreclosia, New Yoke, No Hopeshire, Mess (for Massachusetts), Horrida and I.O.U.wa, is the satirist's and cartoonist's art at its most effective. It tells a story we would prefer to overlook: America's states are drowning in red ink.

And hence to the fourth crisis: geopolitical risk. The Arab world is convulsed. Petrol flirts with $100 a barrel. Food prices have risen above their 2008 peak. Natural disasters are omnipresent. It's suddenly a dangerous place out there.

So what have these four crises done to expectations and a generation of investors, especially those looking at Asia? The answer is not simply bulls vs. bears. Rather, I believe we have undergone an undernoticed shift in psychology that makes us warier of indiscriminate grand trends in investing, embracing whole countries or sectors, and more cautious and careful "opportunity pickers." Of course, trends still matter: Are we shifting our global economy onto an IT-enabled platform? Almost certainly, so that gives the technology sector a step up before you get to evaluate individual companies. Similarly, the long-term future of high-growth markets — namely Asia, Latin America and parts of Africa — seems on a stronger trajectory than, say, Europe or North America.

SEEKING MARKETS WITH MORALS

But let me scratch a bit further at this somber new psychology before applying the same lessons to Asia in particular. In my view, two of the apparently hardwired assumptions about the recent past that came from the 1989 fall of the Berlin Wall have been changed by the 2007–11 credit shock. First, governments are no longer necessarily safer than companies, which throw on its head the most basic principle of portfolio allocation between safe but low-return government bonds and corporate debt and equity. And that came to pass in considerable part because the socialization of Western bank bad debt has implications for Western political systems that have not yet played out. Look out, for example, for the return of hard-left political parties demanding much more draconian anti–Wall Street

and -business measures than anything we have seen so far.

Gordon Brown, who, as England's Chancellor of the Exchequer, presided over the dramatic expansion of the London financial services sector, in his post–prime ministerial memoir waxes angrily about irresponsible and reckless banker greed and demands markets with morals. For a man from Adam Smith's hometown whose political career is behind him, a call for morals may be enough. I suspect younger Labour leaders harbor hopes for taking a clenched fist to markets.

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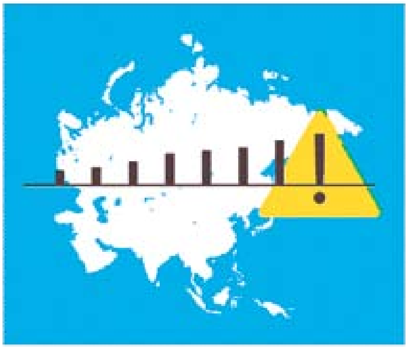
Percentage by which incomes in East Asian countries increased between 1970 and 2010, though income inequalities have grown sharply in a number of these countries

In this way, the "popular capitalism" model of growth that drove social cohesion in Europe from Margaret Thatcher's day onward — where people got richer, bought their own houses, put a second car in the garage and saw their children off to fine, and largely free, university educations — may be ending in tears.

SHADOWS OVER ASIA'S RISE

Although Asia has embarked on a similar inclusive period of political and economic growth, where, despite vast income disparities, everybody feels they could be part of an American-style aspirational dream — where each generation is better off than its predecessors — it, too, will be affected if European markets grind to a halt



and a new "them" and "us" politics metastasizes from Europe into Asia.

But at a time when we are anxiously peering through the telescope and trying to understand future risk, we need to look hard at Asia and the geopolitical factors that threaten to cast long shadows over Asia's rise. What are Tunisia's and Egypt's lessons for Asia?

The first thing to say is that it probably is not the democracy deficit that will trip up Asia in the way it recently has the Arab world. For all its exceptionalism, Beijing remains sharply attentive and responsive to local issues, as though its political life depended on it — and it probably does.

Rather, the roots of Asia's risks are growing income inequality, border disputes, environmental and natural resource pressures, and the scramble to control the strategic commodities that feed the Asian manufacturing engine. On each, there are clouds. Though East Asian incomes have increased by 1,100% between 1970 and 2010 compared with an average of 184% in developing countries, income inequalities have also grown sharply in a number of East Asian countries. These inequalities create new disparities, new winners and losers and new tensions. The 2010 confrontation in Bangkok between angry rural supporters of the opposition and the more prosperous urban groups that supported the government reflected this reality, and it clearly lies behind many of the tens of thousands of social protests each year in China.

Asia entered the 21st century with a positively European, beginning-of-the-20th-century list of unresolved border and sovereignty disputes: the South China Sea, Taiwan, Kashmir, the Korean Peninsula and so on. If Europe's experience a hundred years earlier tells us anything, such disputes are exacerbated by differential rates

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of economic growth. Germany's industrial success fed its resentment at unsatisfactory border arrangements. It wanted more room and power. The other analogy to Europe is that when a region is a global economic powerhouse, its disputes have a nasty habit of going global. Germany's border grudges led us into two world wars.

The region also faces destabilizing environmental and resource trends: Water scarcity in India is one of several factors having a major impact on Indian agricultural productivity; changing dietary habits in China, India and the rest of the region with the substitution of meat for grain requires heavy increases in the use of both grain and water. Environmental destruction of the Indonesian rain forests has made this one of the top hot spots for global climate change. The fact that more than 80% of the world's natural disasters occurred in Asia in the past few years indicates how population growth, poor location of expanding human settlements, soil degradation and the loss of forest cover are combining with more extreme weather patterns to create an enhanced level of human vulnerability to natural disaster.

Beyond these kinds of issues, as Asia faces new competitors, Africa embarks on a low-cost, commodity-export-led boom backed by a lot of internal diversification. Many Asian countries seek strategic partnerships to secure access to Africa's minerals and energy, but this also forces them into mounting a much more global national foreign policy than in the past. There are Indian peacekeepers in Congo, Chinese traders and development experts in Malawi, and both countries' engineers and diplomats, along with those of South Korea and Malaysia, pursuing resource deals across the African continent. Without the same ambition for political control, this Asian scramble for African resources emulates Europe's similar late-19th-century scramble. Asia has its hands full.

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INVESTORS, TREAD CAREFULLY

What does all this mean for the investor? My own view is that none of this undermines the long-term bet on Asia, but it does suggest that investors should be discriminating. The world is a tricky place. Although Asia's concentration of people, wealth and growth makes it an indispensable centerpiece of any global investment strategy, that strategy must be accompanied by a tolerance for risk and the tools to manage it. Too many Western investors still assume that growth will banish politics and that a vast consumer suburbanization is under way across this large and varied region. This way of thinking assumes that with growth, every country will become a Singapore or a Hong Kong, forgetting that both have unique histories and geographical opportunities that enabled them to become high-end service providers and trade centers for their regions. Neither is a replicable model for its much larger, teeming neighbors that are still struggling to make growth inclusive and government viewed as fair and legitimate. For much of Asia, the real dramas of development, political as well as economic, lie ahead.

For the investor, this is not a reason to stop but rather to proceed through these dangerous seas with the right charts. Above all, it requires rigorous understanding of individual corporate strategic plans, financial strength and market positioning. The big trends are sufficiently prone to geopolitical shock, sector risk and continued financial volatility that the lifeboat is the investment target within the trend. Is it the IT company that will survive a bubble or the construction business that can now weather a long downturn? And in cases where the investment is essentially a bet on a country's stability and growth, investors need to do their homework, and above all not fall victim to the wishful thinking that growth equals stability. If the political system is not expanding to represent both the new middle class as well as those who fear they are getting left behind, prepare for trouble. Asia has enough variety of political systems operating effectively that the key test is not a neat Western democratic form but broad representation, accountability and legitimacy.

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GROWING PAINS

Growth will propel this region forward, as well as Africa, Latin America and other emerging regions, even as the mature Western markets fall back. But at times this growth will fall into that category of things we warn our children about: Be careful what you wish for because growth brings the stresses and strains of new inequalities, resource scarcities, infrastructure bottlenecks, inflation, pressure on borders from growing populations, and competition between countries.

In the long run, people will look back and see a generation of difficulties and wonder why we had not seen it coming, and why, when it came, some probably lost sight of the more lasting truth. These difficulties were growing pains and not a lasting threat to Asia's rise. What investors must surely do is keep their heads and hold on to their wallets in the coming years, while never losing faith in the region's transformation. Markets have never been so global and yet local knowledge so important. ■

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