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REMEMEBRING THE FUTURE
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Where China Meets Russia: The Investment Case for Mongolia

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Introduction

As an introductory statement to this newsletter, allow us to state that we are of the opinion that we are on the verge of a reality transition that could unfold in the next 2-3 years. That transition will include a process of strategic disintegration similar to the one that the world experienced in the mid 1910s, in the mid 1940s, and at the end of the 1970s. In the midst of this devolution the global pricing mechanism is supposed to uncover dormant assets.

Our last newsletter was dedicated to the issue of natural gas – which we consider to be a dormant asset - as the bridge fuel toward the era of renewable energy. We were happy to see our clients profiting through the significant gains that natural gas has experienced in just five weeks. While we realized those profits we still believe that natural gas will be part of the transition as energy policy is re-written in the US, the EU, and around the globe.

This month we make the case for Mongolia. We believe that it is a case worth looking at for investment purposes, either directly or indirectly via a proxy, such as companies that invest heavily in Mongolia. We will primarily let the numbers make the case for us and we will be adding some comments where needed.

Some Basic Facts about Mongolia

Let's start with the geographic location. The maps below help us visualize that Mongolia is indeed between China (to its south and east) and Russia (to its north). Its nose touches Kazakhstan to its west. The terrain includes mountains, desert plains, steppes, and lots of minerals (copper, tin, zinc, gold, silver, oil, coal, nickel, iron, etc.)

The most famous person from Mongolia was of course Chinggis Khaan. His death forced the empire to retreat into separate Mongol states (13th century) which eventually broke apart in the 14th century. The Chinese ruled Mongolia starting in the 17th century. The Russians supported their independence which they won it in 1921. The Communists ruled Mongolia until 1990. Since then the former Communist Party (MPRP) has won the elections on several occasions. As of last month the MPRP – renamed into MPP – was at the head of a coalition government with the Democratic Party of Mongolia. The current transition government will be in power until June 2012 when elections are scheduled to be held.

Mongolia's parliamentary democracy has made significant steps towards openness, the application of the rule of law, transparency and a friendlier business environment that would attract foreign investments.

Mongolia exhibited a significant growth rate of more than 6% in 2010 followed by more than 9% in 2011 and is expected to have double digit growth rates for at least the next six-seven years. The main reason for such growth is the fact that Mongolia is experiencing a transformation due to its mines. Its minerals have attracted significant capital and are experiencing a boom.

In the last twenty years the Mongolian economy has experienced waves of privatization, high growth – largely due to copper prices - accompanied with high inflation. The financial crisis of 2007-'09 hit Mongolia very hard with government revenues falling drastically while its banking sector was shaken pretty badly too. The IMF's program of 2009 stabilized its finances (currently running a budget surplus of more than 5% of GDP) and its financial sector (which is lending again at a very healthy rate, given the state of the economy and its prospects) while better regulatory environment is instilling confidence again. Recent legislation to develop particular mines and economic fields (especially the Oyu Tolgoi a.k.a. OT & the Tavan Tolgoi mines) will allow Mongolia to mimic the export-led economic growth model of other Asian countries and will place the country among the top economic performers in the foreseeable future.

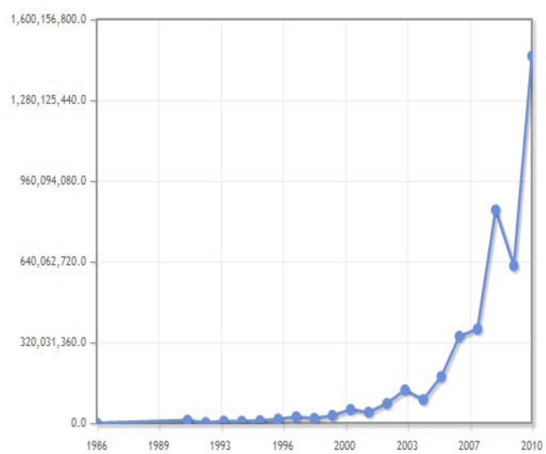
Mongolia's heavy dependence on Russian energy sources is considered a weakness. At the same time its dependence for both imports and exports with China could be considered another weakness especially if Chinese growth starts slowing down. A concern is always present regarding the "resource curse" where a country blessed with resources reverts to corruption and underdevelopment. Another fear is that Mongolia may suffer from a Dutch disease – where incoming capital flows raise its exchange rate substantially (Mongolian togrog appreciated more than 15% against the US dollar in the last two years) to the point of hurting its exports – while issues of corruption and inflation are still visible and threatening its prospects. Its major economic sectors (agricultural, industrial, and services) are all growing at a healthy rate and are helping reduce the unemployment and poverty rates.

Mongolia has been building external firewalls in terms of lower debt/GDP ratios, higher foreign exchange reserves and higher exports so that it can withstand some temporary shocks.

Mines & Foreign Direct Investments in Mongolia: The Cornerstone of Growth[1]

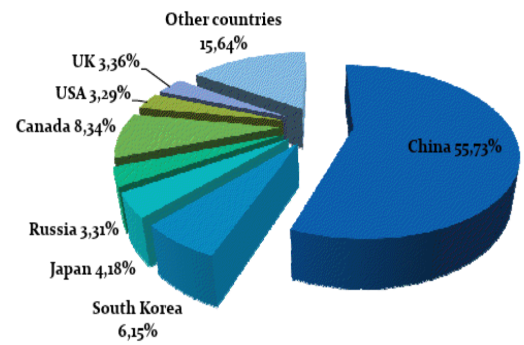
The Oyo Tolgoi mine is expected to account for close to one third of Mongolia's GDP within the next 6-8 years. Naturally, it has attracted a lot of attention and capital from around the world. In just a few years time, more than 2,800 mining permits have been issued, for what is expected to be the Mecca of mining work. Hence, it is no surprise to see the following graph of foreign direct investments (FDI) into Mongolia.

Foreign Direct Investments in Mongolia



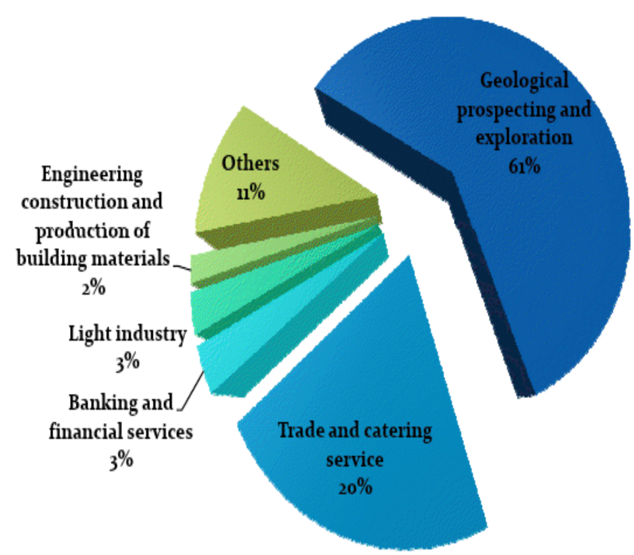
In the next graph, we see the breakdown of FDIs by country of origin. Again, it is no surprise that China's share exceeds 50%, given its geographic proximity as well as its appetite for minerals, in order to feed its industrial complex. The prospects for Mongolia are great, given its vast resources in hard assets. If global inflation starts picking up pace worldwide, then Mongolia will benefit since hard assets retain their value in inflationary times.

Breakdown of FDIs by Country



Finally, we should point out the industry breakdown of the FDIs. The following graph verifies our claim that the mining sector is the cornerstone of growth like LNG was for Qatar, and copper was for Chile.

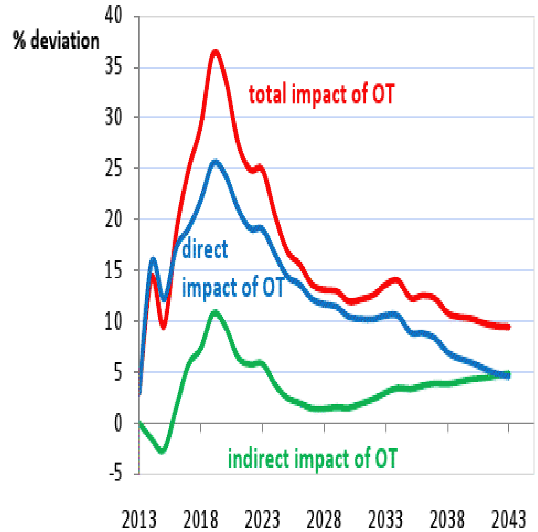
Industry Breakdown of FDIs



Conservative scenarios and simulations run show that GDP per capita will increase by at least one third by 2020 just because of the OT mine as the following graph shows.

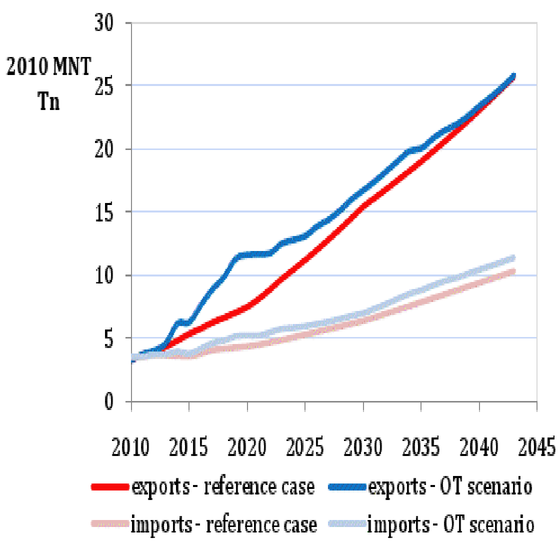
[1] Data and figures were taken from World Bank's database of countries as well as from a study/macroeconomic assessment for Mongolia performed by the School of Economic Studies in conjunction with Australian economist Brian Fisher.

Projections of the Effects on GDP per Capita



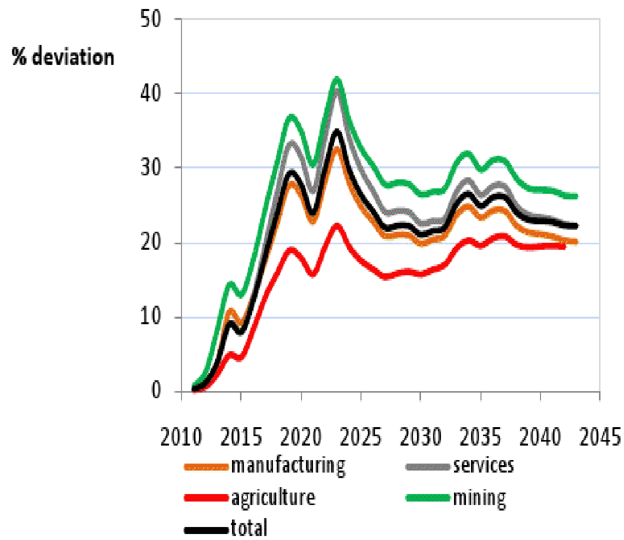
If copper prices increase modestly then the impact of OT on the economy will be much higher. But even with a conservative estimate, just one mine's (OT) impact on Mongolia's international trade will be substantial. As the following figure shows, by 2020 OT is estimated to boost exports by 55%, and imports by almost 20%, eliminating trade deficits and advancing personal income.

Projections on International Trade



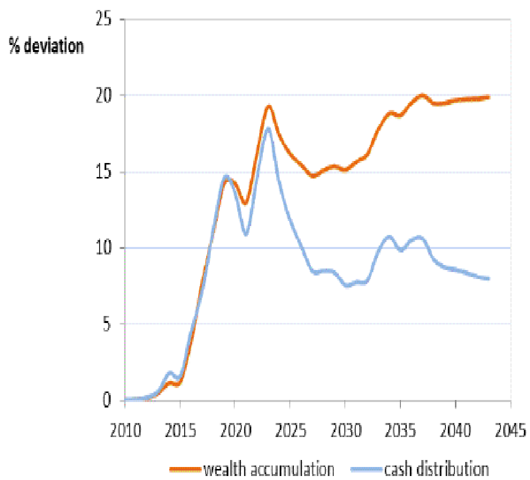
The combination of the above will result in the creation of a middle class in Mongolia whose real purchasing power will increase close to 30% just because of OT's dynamics as the simulation results show below. The interesting thing to note is the spillover effect in other industries' real wages, again as shown below.

Projections on Wages



We only hope that all of the above will result in better policy, where Mongolia – like Norway – will create a wealth fund where surpluses will be accumulated for future generations. The following graph demonstrates the impact on GDP of just one project (OT) under a cash scenario (where the benefits are mostly distributed as cash to current generation) and a wealth accumulation scenario. The picture speaks for itself, as to what needs to happen.

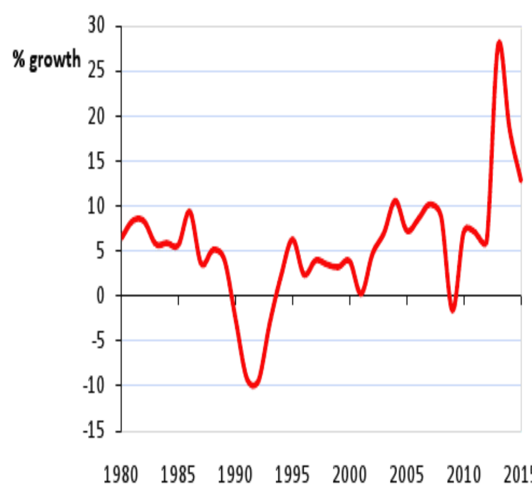
Projections of the Wealth Effect



The Future is Here

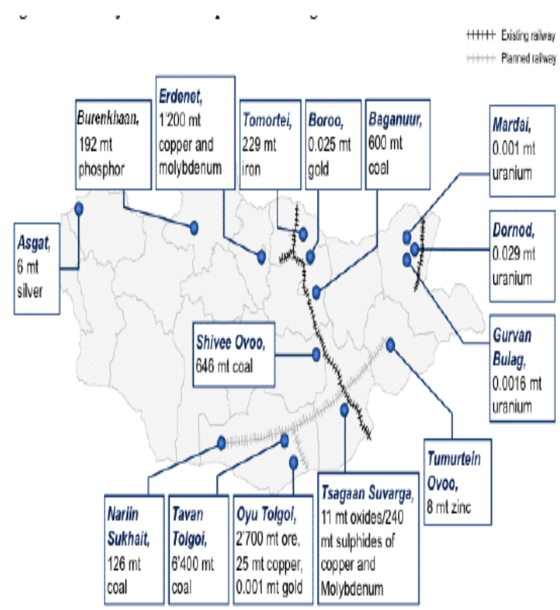
Mongolian GDP growth rate is not something yet to take place. It's here and now as the figure below demonstrates.

GDP Growth Rate



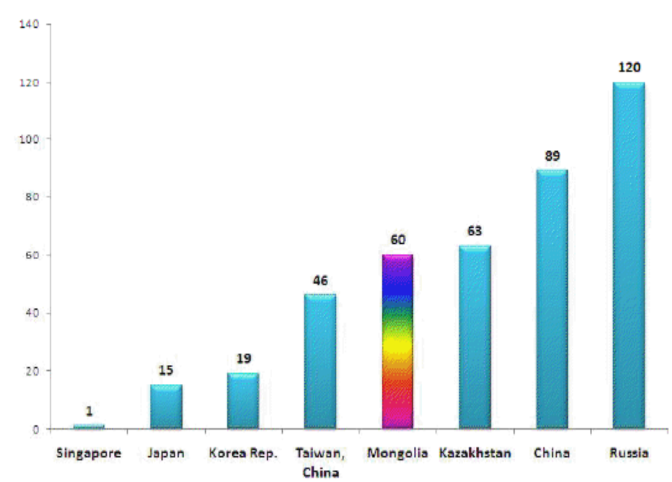
The astonishing projected growth rates will place Mongolia at the top of developing countries and will empower other industries as well as the exploration of other mines. The map below shows the potential of other mines.

The Impact on Other Mines



As the economy expands and business sectors grow the anticipation is that the regulatory environment will accommodate growth and expansion. The graph below portrays the easiness of doing business in Mongolia.

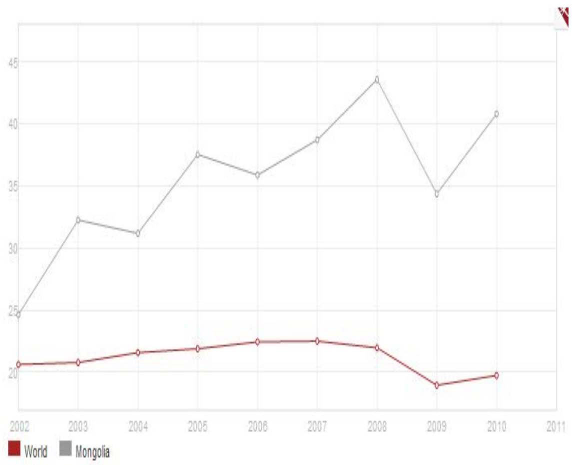
Ease of Doing Business



By no means could we portray Mongolia as Singapore or other Asian tigers such as Taiwan or S. Korea. However, it is ranked significantly higher than China and of course Russia. Its relative strength in terms of ease of doing business is expected to increase more as the new government takes over in the middle of this year.

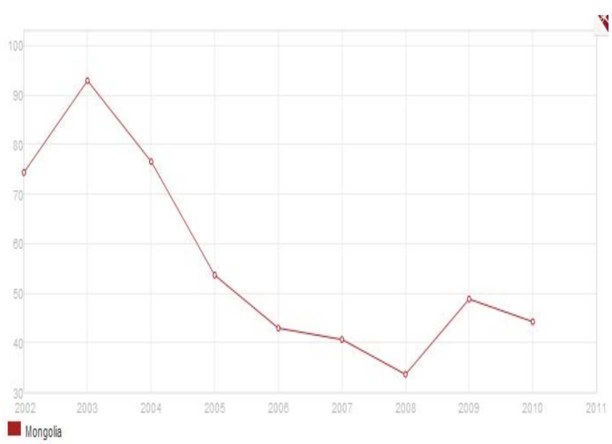
Such strength can only be approximated by the vote of confidence given to Mongolia through capital formation. The following figure is indicative of that trend. Since 2009 capital formation in Mongolia is significantly higher than the world's average and is expected to increase even more in the next several years.

Gross Capital Formation: Mongolia vs. the World



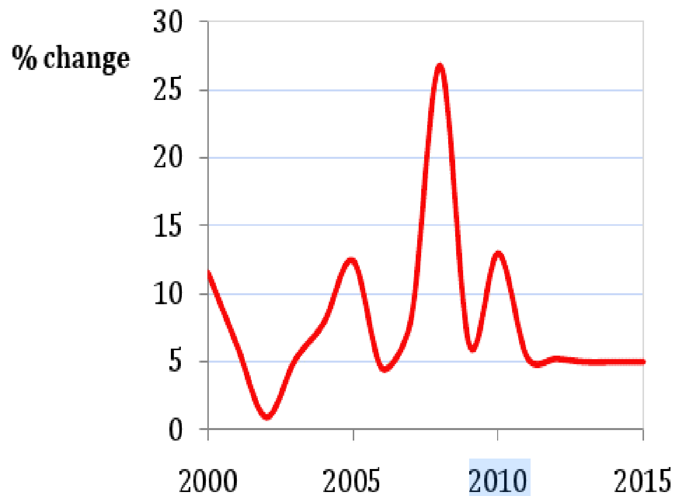
The higher rates of capital formation are responsible for the reduction in Mongolia's external debt as the following figure shows.

External Debt as a Percentage of Income



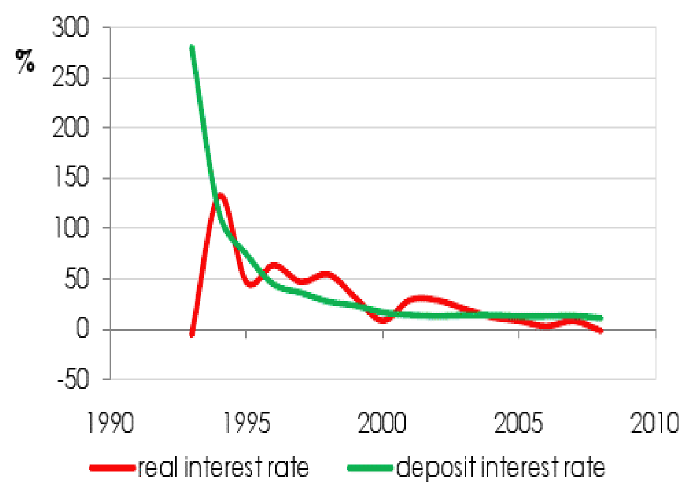
As external debt declines savings accumulate through interest payment reductions which in conjunction with the FDIs, advance growth, employmentand financial stability, while reducing inflationary pressures, as shown by the graph below.

Inflationary Pressures



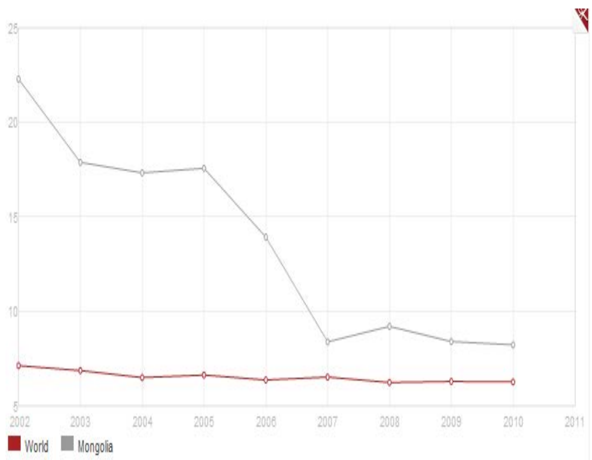
As financial stability emerges, real interest rates decline which in turn allow business development, feeding employment, incomes, and upward mobility. The figure below shows that Mongolia is well on its way there.

The Impact on Interest Rates

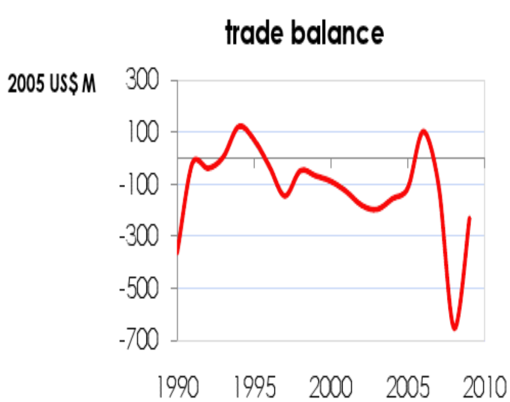


As financial stabilization takes place the spread between lending and deposit rates should decline in order for business confidence to increase and investments to take place that would in turn support higher consumption and living standards. The figure below shows us that such decline is materializing in Mongolia, which in turn affirms the stabilization hypothesis.

Interest Rate Spread (Lending-Deposit Rate)

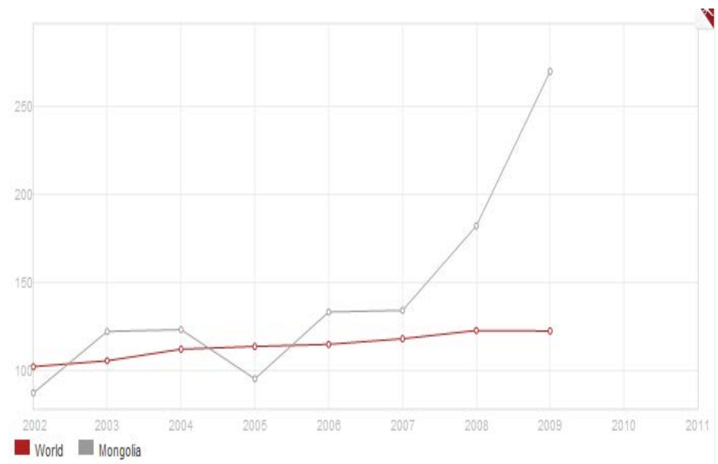


Financial stabilization will also advance the cause of trade balance. Actually, it is expected that Mongolia – well into its way of eliminating its trade deficit, as shown below – will start enjoying trade surpluses pretty soon.

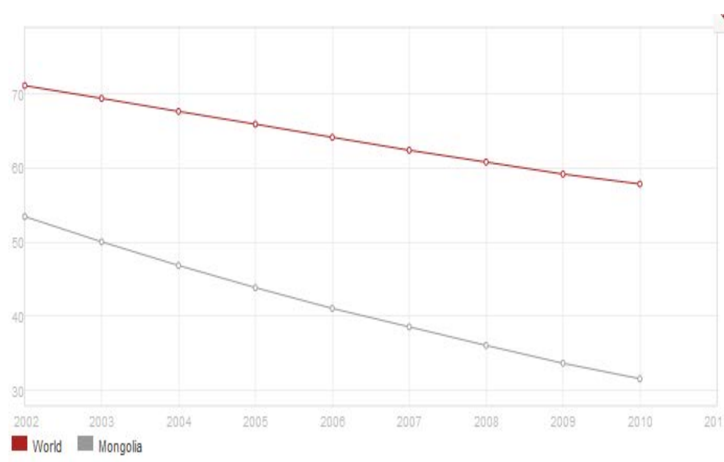


While Mongolia's competitive advantage is certainly in the area of minerals, the FDIs and the capital formation have positive externalities in other major sectors of the economy such as agriculture, health care, and education. The graphs below demonstrate those positive side-effects on crops, on mortality and on school completion rates. The country seems to be creating the social infrastructure that is necessary to sustain upward mobility and a middle class.

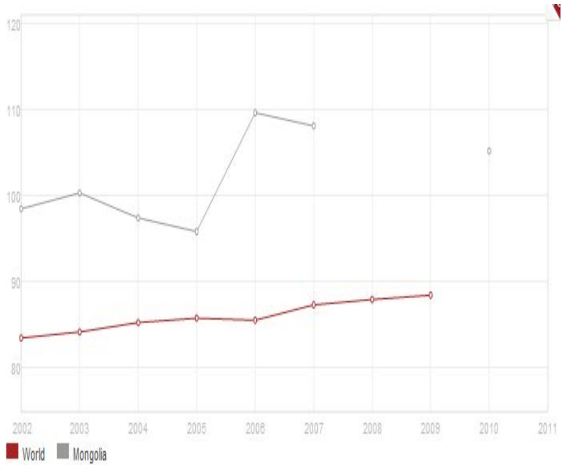
Crop Production Index



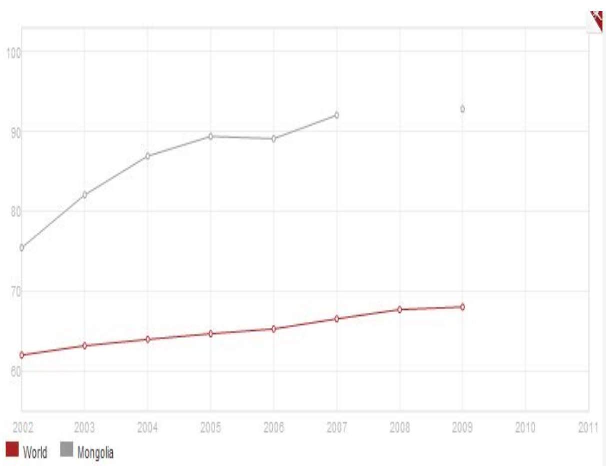
Mortality Rate Under Age of 5



Primary Completion Rate

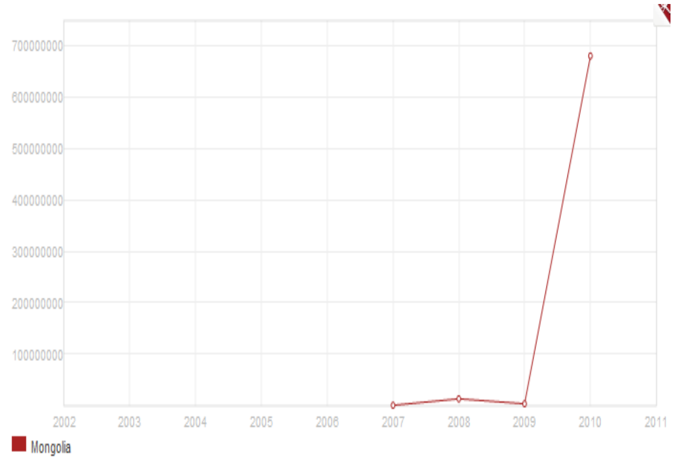


Secondary School Enrollment



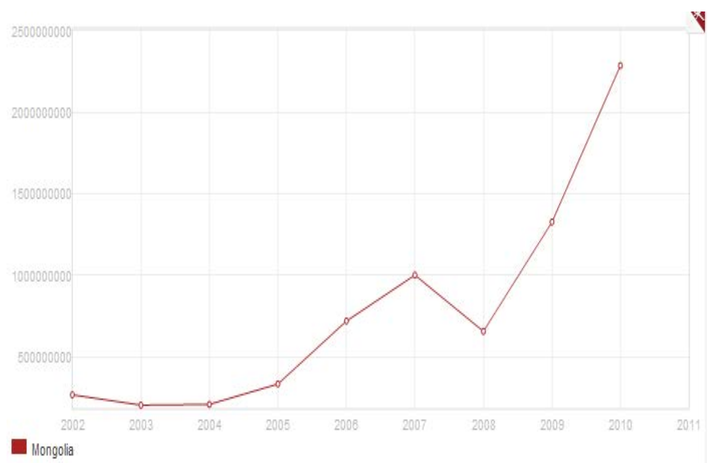
It has been the case in other developing countries where FDIs do not translate into portfolio equity inflows that empower businesses, meet capital needs, promote business formation, and assist capital markets in their formative years. The case of Mongolia is pretty encouraging in that perspective too, as the graph below shows.

Portfolio Equity (equity inflows net of FDIs)



The combination of FDIs and portfolio equity, allow a developing country to build the necessary cushions that may be useful in times of external shocks. The graph below demonstrates that Mongolia is performing well in that perspective too.

Foreign Reserves



Concluding Remarks

In the proceeding pages we tried to show that it may well worth it for someone to consider Mongolia into a portfolio that includes an emerging markets section. In the past we have had cases, such as Chile, Quatar, Malayasia that resemble that of Mongolia. Mongolia has a lot to learn from countries that upheld the rule of law, created wealth funds, accumulated savings, advance physical and social infrastructures, reduce corruption, and invested in the future. Maybe in the next decade the business people in Asia will be meeting at the intersection of China and Russia as they contemplate the era of state capitalism.