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Measuring Value®
Global Capital Markets, Sectors, and Trends

Capital markets in the context of global growth

In the previous issue of Measuring Value, we examined several measures of major equity markets, focusing on geographic spread of their listing. In the second issue of this series, we will examine the sector profile of markets and potential future trends.

As we enter 2013, data from all regions of the world remain mixed, and little is in sight that reduces the uncertainty that prevailed throughout 2012. We continue to face volatility in commodity prices, negative or sluggish economic growth, negative growth of manufacturing, persistent unemployment, property market volatility, and stubbornly slow progress toward resolving numerous trade and investment disputes. But we should also not lose sight of signs of stability, which include relatively stable exchange relationships among major currencies, including the Euro, some signs of recovery in many major economies, continued focus among leaders of major economies on recovery, continued fluidity in global flows of capital, and reasonably strong growth in most of the world's capital markets. 2013 is beginning as a good year for capital markets.

Reasonably strong growth in capital markets has not been evenly experienced in recent years, however. At the end of 2012 we looked back at relatively weak performance by the equity markets in the world's biggest emerging economies, even though as a group, big emerging economies lead the developed world in GDP growth by a big margin. This was the third year in a row BRIC indexes lagged global indexes. The MSCI BRIC Index (MXBRIC) of shares in Brazil, Russia, India and China rose 11 percent last year through Dec. 28, trailing the MSCI All-Country World Index by 1.6 percentage points.

Why the economies that led the world in GDP growth have experienced relatively weak performance in their capital markets is an important question. Global business media have begun to discuss this, but so far answers have been varied and incomplete. What is evident is this: what drives performance of any equity market includes factors quite apart from the performance of the related, underlying real economy, many related to government roles in the economy, governance of the listed entities, prospects for dividends, recent boom and bust traumas, and overall confidence in the economies.

Understanding performance factors that account for the mid-term and long-term performance of individual equity markets is important. Weakness in equity markets impedes growth, primarily by constraining availability of growth capital for any economy. It is estimated that Brazil may have an equity shortfall approaching US$1 trillion. High functioning equity markets are a critical alternative to bank financing as capital needs of emerging markets soar with the growth and diversification they are all experiencing.

FDI continues to play its role in supplying capital to emerging economies. Total foreign investment for 2011 reached approximately US1.5 trillion, and for the first time, more than half went to developing and transitional economies.

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If equity markets based in emerging economies continue to underperform, the better liquidity in developed markets will drive emerging market companies overseas, and that in turn drives them into other challenges, some of which we discuss below. Brazil's state-run Petroleo Brasileiro SA and Russia's state-owned OAO Gazprom are more actively traded abroad than on their domestic exchanges. The 30- day average value of trades in 10 Russian companies including Gazprom is 62 percent higher in London than in Moscow. It is worth considering the implications both for BRIC capital markets and markets like Singapore and Hong Kong that bridge emerging economies to global networks.

As sectors and sub-sectors become more diverse and complex, so do the service ecosystems in which they operate. In the previous issue, we discussed the level of specialisation in Toronto. A successful example of sector specialisation, Toronto raises the possibility that sector specialisation may prove a competitive advantage for capital markets and financial centers in the future.

Finally, whether global capital markets can continue trending toward greater levels of inter-operability depends on whether a number of challenges, mainly regulatory, can be overcome. The market interest in global traffic is intense. Although policy and regulation are defined within national boundaries, massive market interactions cut across boundaries, sometimes even arbitraging differences to the advantage of fast-moving market players. Currency trading alone, which by definition is cross-border, exceeds US$4 trillion daily. Global trading in currency constitutes the world's largest financial market.

An initial look at sector profiles

Analysts who serve institutional and individual investors of all sizes focus both on individual listed enterprises and on sectors. Analysis of sectors tends to set benchmarks for key performance indicators, like P/E ratios, growth expectations, dividend norms, market share analytics, and the impact of global environmental and regulatory change. So, traditional energy stocks, as a class, are collectively impacted by an anticipated slowdown in China's consumption of key commodities and resources. Healthcare stocks, as a class, are sensitive to developments with the Affordable Care Act in the United States. Cleantech energy stocks are sensitive to subsidy policies in major markets around the world and massive shifts in supply such as the US shale developments.

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Some markets, like the Nasdaq and AIM, are established and designed to support specific sectors that dominate the fast growth, relatively high risk landscape. Other markets are by definition agnostic about sectors. But even in equity markets with no policy or selection bias for particular sectors, the historic shifts in sector dynamics that are part and parcel of the growth of any economy impact the sector profile of related equity markets, generally evolving from basic commodities and services, industrial production, and perhaps export, to financial services, technology, energy, and higher value commercial and consumer services.

As an initial step to deepen our understanding of sector profiles and capital market development, we looked at the profiles of three stock markets that do not represent themselves as sector or scale specialised, New York Stock Exchange, Shanghai, and Hong Kong.

There are three caveats to mention at the beginning. First, the data are somewhat rough, in that the categories of data published by the exchanges are not completely consistent, but we are looking more at the internal ratios of each exchange. Secondly, the relationship between sector profiles and the very different performance of these markets and their indexes over the last three years is unclear, although sector analysis, as we described above, is clearly relevant to investment decisions.

The third and very significant caveat is that we are looking at the number of listings, not the aggregate market value of the sectors being compared. A more complete analysis would look at both. The contrast between number of listings in a sector and the aggregate market capitalisation of a sector makes an obvious point about concentration, diversity, and competition within a sector. That in turn has both positive and negative impacts on investor decisions as well as enterprise decisions on where to list.

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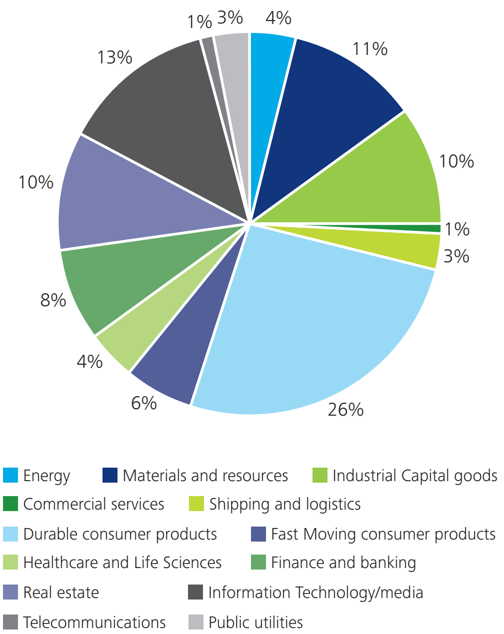
We take three major points from the table 1 and related pie charts.

Table 1

Industry	ChiNext	Shenzhen	Shanghai	Hong Kong	New York
Energy	6	10	36	54	242
Materials and resources	51	150	165	171	184
Industrial capital goods	68	162	172	154	123
Commercial services	12	13	4	19	73
Shipping and logistics	3	10	56	50	65
Durable consumer products	29	131	167	403	307
Fast moving consumer products	10	48	68	89	124
Healthcare and life sciences	40	43	54	63	118
Finance and banking	-	3	31	130	266
Real estate	-	8	82	153	161
Information technology/ media	131	116	71	209	174
Telecommuications	-	2	2	17	56
Public utilities	4	2	46	39	99
Total	**354**	**698**	**954**	**1,554**	**1,992**

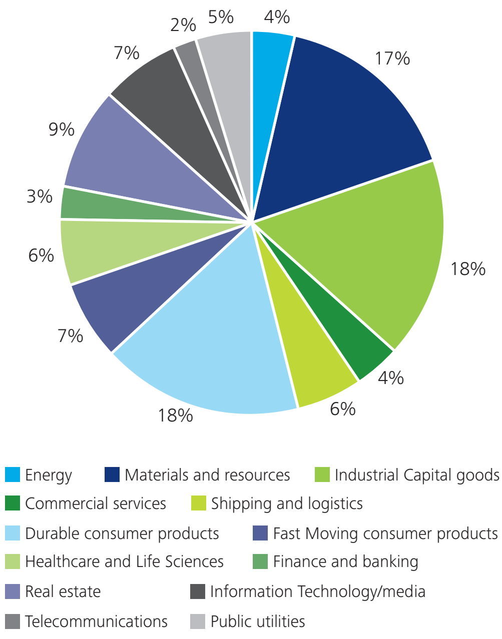
First, the three markets are highly diversified across the 13 categories into which we grouped their listings. If we take the three largest sectors in each market as a percentage of total listings tallied, the three markets are remarkably similar. New York and Shanghai appear to be the most specialised market, with the top three sectors representing nearly 53 percent of their total listings. Hong Kong is not much different, with something around 50 percent of its listings in the top three sectors.

Hong Kong*

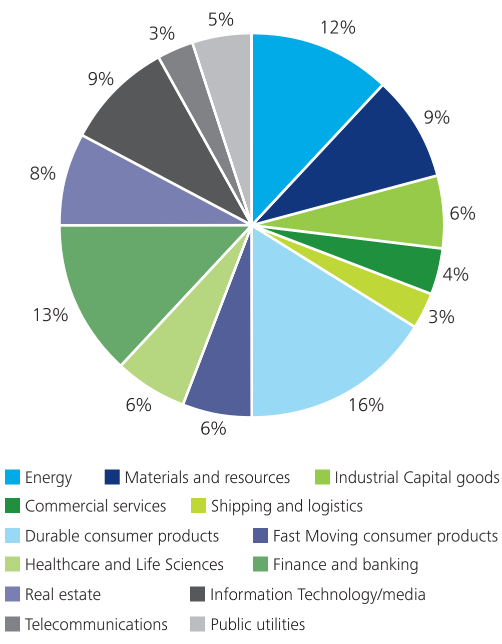


* Data for Shanghai and HK markets are updated to 7 January 2013, and the data for NYSE are updated to 31 December 2012.
Source: Wind, Dow Jones

Shanghai*



NYSE*



Secondly, different sectors dominate the three markets. Over 50 percent of Shanghai's listings are companies in materials and resources, industrial capital goods, and durable consumer goods, reflecting the key role of these manufacturing sectors in capital deployment and reform era growth.

In New York, the dominant sectors also include durable consumer products but then are dominated by finance and banking and energy, reflecting New York's global role as a banking and finance center as well as its highly developed market in derivative products related to sectors like energy. In Hong Kong, the durable consumer products sector is also the top sector, and the other two are IT and media, and materials and resources.

The third point derives from our third caveat, the difference between number of listings and total market value of a sector. In New York, there are 56 telecommunications companies listed; in Shanghai there are two. The aggregate market cap of the top two telecommunications listings in New York is US$326 billion, and in Shanghai it is $13 billion. China's largest telecommunications operators, China Telecom and China Mobile, do not list in Shanghai.

Finance and banking reveal more clearly the special concentration characteristics of certain listings in the China marketplace. In finance and banking, New York has 266 listings; in Shanghai there are 31. The aggregate market value of the five largest banks listed in New York is US$506.9 billion, but in Shanghai it is US$760 billion. These contrasts are a reflection of the way in which the economy is structured, the ownership role of the state in key sectors and related regulation, the level of competition, and the stage of economic development.

What direction from here?

In an era of globalisation and relatively open flows of capital, markets as a group will trend one way or another in the next few years. They will either trend toward more comprehensive and inclusive sector profiles or toward more specialisation. If markets follow the history of major industries and enterprises, the latter is the more likely direction. Increasing scale and strategic specialisation, based on core competencies and many other elements of competitive advantage, are common characteristics of enterprises that dominate share in the global market landscape. Even though in business cycles we experience waves of mergers and acquisitions that drive some product and service diversification, the era of broad conglomeration has clearly given way to a sustained era of focus and clarity for corporate brands and competencies. So it will likely be for equity markets.

* Data for Shanghai and HK markets are updated to 7 January 2013, and the data for NYSE are updated to 31 December 2012.
Source: Wind, Dow Jones

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For both regulators and financial service providers, following this aspect of development will be critically important to fuel growth of the markets in which they operate. Just as MNCs drive scale as they foster specialisation by increasing their "multinational" market footprint, sector specialisation in equity markets will drive geographic diversification and reach. That in turn will reshape the financial service ecosystem around any particular market, with pressure, or perhaps opportunities, to harmonise and integrate financial, legal, reporting, and consulting services on an increasingly global scale.

If in fact Asia's major capital markets trend toward specialisation, and as a consequence drive toward broader geographic footprints, they will expand their role as primary contributors to Asia's integration. The complementarity of the real economies in Asia is strong, among resources rich economies like Indonesia and Myanmar, advanced manufacturing economies like China, Thailand, South Korea, and key service economies like Hong Kong and Singapore. The growing wealth in Asia will enable the key capital markets, especially in Hong Kong and Singapore, to meet the growing capital needs of economies like Indonesia and Myanmar, a glowing example of the "win-win" path that many Asian leaders have promoted.

Equity markets and financial centers in a broader context—challenges to an orderly future

Global financial centers serve domestic and international goals, and they are predominantly shaped by their capital markets. Domestically, not only do they serve the capital exchange needs of growth enterprises and investors, but they also are the major meeting ground of national regulators and national enterprises. Internationally, they are also the meeting ground for national regulators with non-domestic enterprises, domestic investors with non-domestic investment opportunities, and non-domestic enterprises with regulators they do not know well.

Arguably the biggest challenge to the optimal workings of equity markets globally is the challenge national regulators and investors face with diverse business cultures, and, conversely, the challenge companies from diverse business cultures face as they reach into equity markets in economies where they have no operating footprint.

A mirror image of these issues is reflected in financial and business service companies, banks, investment funds, accountancies, law firms, and consultancies. In the last decade, they have experienced a surge in client demand that has forced innovation in and integration of global services, with significant internal restructuring. Externally, they have been called upon to execute a higher level of inter-operability among diverse national systems of regulations and the diverse cultures of compliance they regulate. Since the global financial crisis, much attention has been paid to the potential contribution of key international institutions in restoring a new, sustainable global financial order. But it is the financial and business service sectors that are in the trenches every day, dealing in an immediate and practical way with the regulatory and cultural challenges of global market interactions.

Among many uncertainties in the global financial landscape, one certainty is that since the crisis in 2008, evident but deeply-rooted differences in what we might broadly call cultures of compliance have emerged to slow progress toward optimal global capital flows. It has not been the most widely discussed global issue since the crisis, but it might well be one of the most important.

The alternative to making progress on these issues is a gradual de-globalisation of equity markets, with more companies choosing to remain in or return to the markets of their origins, registration, or asset base. Were this to happen, what we might call the "reshoring" of companies to capital markets at home will likely provide some near-term boosts to some markets. But considering the shared interests of all leaders in the sustained improvement of living standards and quality of life for their citizens, the benefits of free flows of capital globally and the most optimal deployment of the world's limited material and financial resources should be uppermost in mind.

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