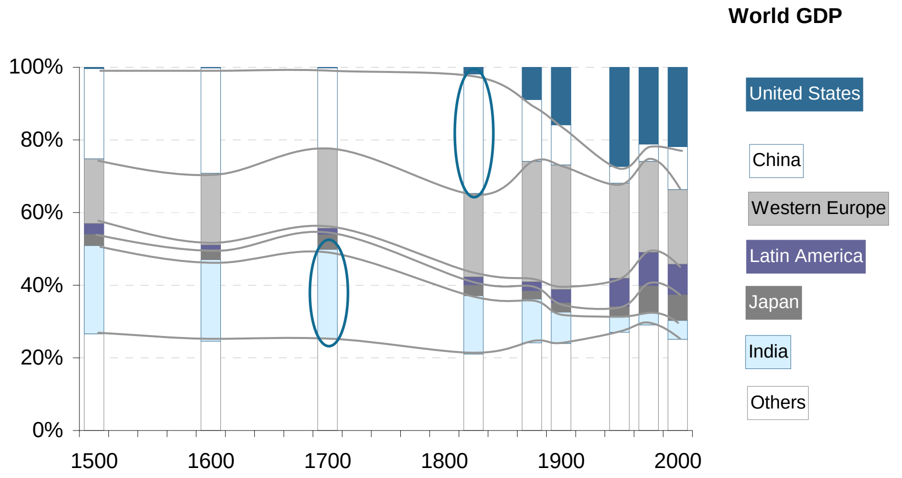
The Passing of the Baton

The end of 150 years of western domination and the rise in emerging markets

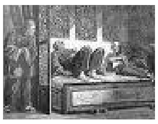
At the start of the 19th century, the world economy was dominated by the two Eastern giants. In the early 1800s, China accounted for 30% of the world economy and was by far the world's largest economy. A century earlier, India was probably the biggest economy on the planet, with about a quarter of global GDP.



Source: Angus Maddison, University of Groningen

In the middle of the last century, in the wake of the Industrial Revolution, there followed a series of events within a mere two decades that led to the western-dominated world that we have known for the last century and a half.

These were:

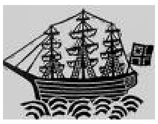


1858

The end of the Opium wars and the treaty of Tianjing, which led to the emasculation of China

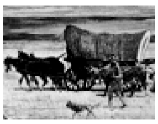
1858

Formalisation of the British Raj in India



1854

Convention of Kanagawa followed in 1868 by the Meiji Restoration – the opening up of Japan to outside influences



Up to 1853

Westward expansion of the US (Texas 1845, Oregon 1846, Mexican Cession 1848, 1853) and the completion of the contiguous USA

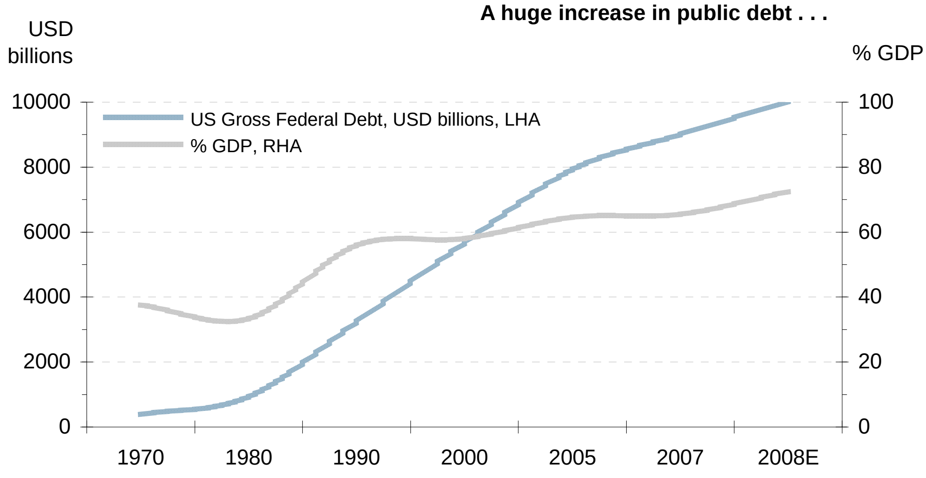
1871

Unification of Germany

Following these seismic changes, an increasingly globalised economy was now in the hands of a small number of countries – the great western powers plus Japan. By contrast, giants such as China and India were rapidly reduced to shadows of their former selves, at least in relative terms. By 1900, Western European economies were already 50% larger than the combined size of the two eastern powers. This gap then widened to the extent that by the 1980s, Western Europe was almost three times the size of India and China together, in terms of GDP. This development was in no small part due to inward-looking policies by the Asian powers, broadly from 1950 to 1980, that verged on the suicidal. A group of countries, with a combined population today of less than a billion, have broadly controlled the destiny of a planet whose population is approaching seven billion for the last 150 years.

It is clear that this control has come at an increasing economic cost. As shown below, the US national debt increased more than 10-fold in less than 30 years, from 33% of GDP to 73% this year. Japan's public debt is about 150% of GDP, up from 52% in 1980, Germany's around 65%, from 33% in 1980.

A huge increase in public debt . . .



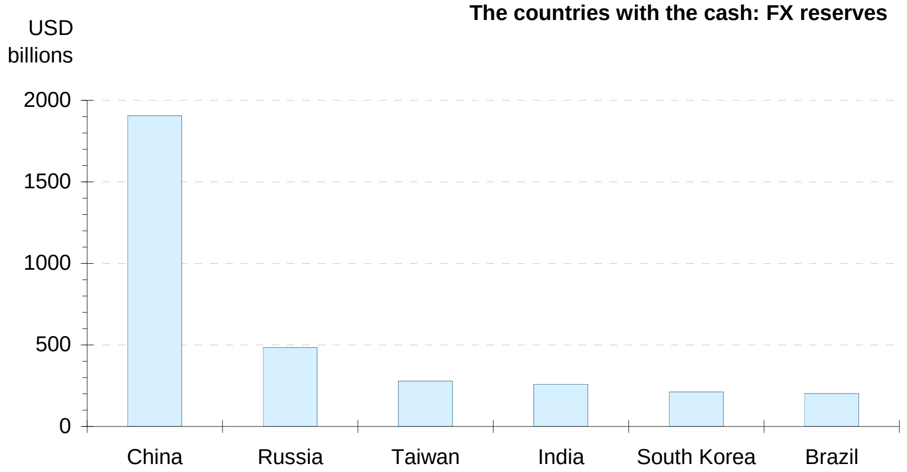
Source: Bloomberg

At the same time, levels of private sector debt, in the US and elsewhere in the West, have risen markedly. Put simply, people, as well as nations, are increasingly living beyond their means. The personal debt/income ratio in the US has almost doubled, from 70% to 130% in just 20 years.

Debt is theoretically supported by ability to pay, (i.e. by current income) and by expectations of future income. A rise in the ratio is sustainable only for as long as asset prices rise. In reality, this means the prices of houses and, to a lesser extent, other financial assets such as equities. And we know where they have gone in the last year: for US homes, - 25% and falling, for US shares, - 40%.

The flip side of this whole dynamic has been an export boom and the amassing of reserves by emerging markets countries. And it's these countries to whom the West has become increasingly indebted. Principal of these is China, but the list includes those other emerging markets countries which have run current account surpluses over the last decade.

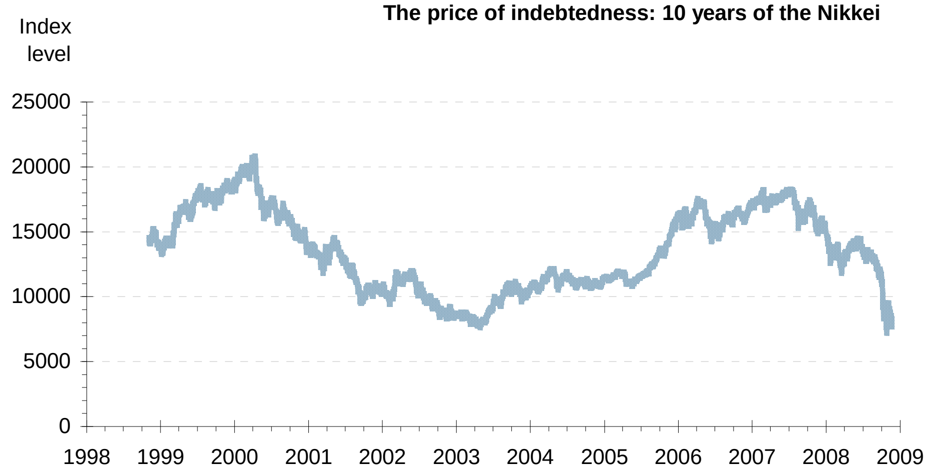
The countries with the cash: FX reserves



Source: IMF

Now the great deleveraging in the West is well into its second year. The cost of all this will be paid for by western taxpayers over the next decade as the government's role in the economy grows. To see what is likely to happen in most of the West, just look at what has already happened in Japan and Italy. In the 1990s, they were the two most indebted major economies in the world. It is no surprise that these have been among the world's slowest economies in the last decade and more. Would you have wanted to invest in Japan over the last decade? This, I fear, is the sign of things to come for the US and Europe. What little growth there has been in Japan in the last decade and more has been due entirely to export growth, a prop that is unlikely to be as supportive in the coming years.

The price of indebtedness: 10 years of the Nikkei



Source: Bloomberg

So what does this imply for investors? Firstly, developed markets are destined for a period of low growth. People and governments will spend years rebuilding their balance sheets. Policies aimed at stimulating consumption are destined to fail. It's easy to overlook quite how bad the state is at allocating capital – just look at those economic decisions made by China and India in the mid-to-late 20th century referred to above. More government involvement will mean poorer capital allocation and less innovation, which means lower productivity growth, lower economic growth and increasingly debased currencies. This means that their imports will stagnate or fall, which in turn means that exports in emerging markets, and therefore the latter countries' growth in foreign reserves, will slow or be reversed. This in turn is bearish for the long term recipients of FX reserves such as the US Treasury bill market. In addition, emerging economies will increasingly use their substantial reserve cushion to fund domestic economic activity. This in turn, I suspect, puts a floor on commodity prices in the long term – has anyone else noticed how no-one is talking about Indian demand for commodities, as if over a billion people have simply disappeared off the map?

The second implication is this: the slowdown in emerging markets is temporary, in contrast to that of developed markets. The 'decoupling' argument – the view that emerging markets can perform while their more mature cousins stagnate - has been shown to be at best premature, at worst wrong. This time, however, emerging markets are now of such significance – almost 50% of global GDP on a 'purchasing power parity' basis – and their economic ammunition is such that they can increasingly lead the world economy and not follow. And this is the heart of my argument. Emerging markets, led by China and India, are set to resume their leadership of the world economy after a hiatus of 150 years. This growth will not be a matter of fuelling western consumption: it's the domestic consumer who will take up the baton. Implications for investors are massive. Currently, 80-90% of the value of the world's stock markets (depending on one's definitions) are in developed markets such as the US, Western Europe and Japan. Using a benchmarking approach, it therefore follows that 80-90% of an investor's equity investments should be in developed markets – even though these countries represent only 50%, and shrinking, of the world economy. Does this really make sense?

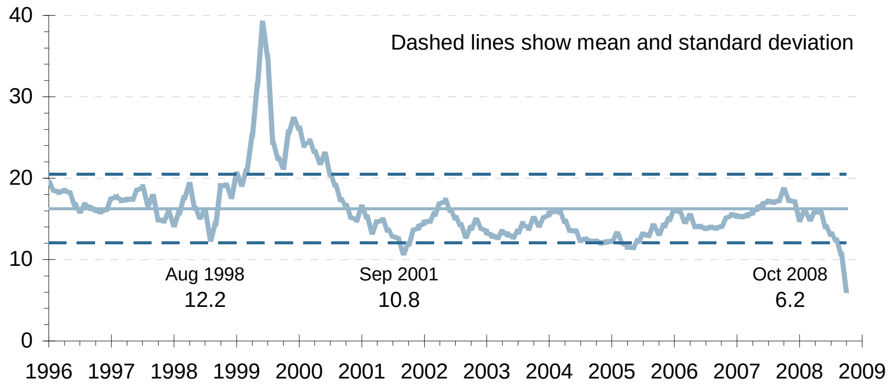
Emerging Markets as a percentage of the World

	Emerging markets	Developed markets
Market cap (float adjusted)	9	91
Market cap (full market)	20	80
GDP at PPP	47	53
Foreign exchange reserves	73	27
Population	83	17

Sources: Merrill Lynch; BP; CIA World Factbook; IMF World Economic Outlook; MSCI

One of the consequences of the current crisis has been a reduction of risk appetite. This has led to an underperformance of emerging markets relative to developed markets this year. While this may be logical in the short term, longer term it makes no sense at all. In our view, investors need a totally different approach to what is meant by 'risk'. To us, risk is investing in low growth countries with increasing state intervention, the inevitability of rising taxation and currencies being eroded by the printing presses. At the very least, most investors should look to have a substantially greater allocation to emerging markets equities than they do at present. The recent falls in emerging markets have presented a very attractive entry point, with PE multiples at record lows.

GEMs trailing PER: Cheap by historic standards

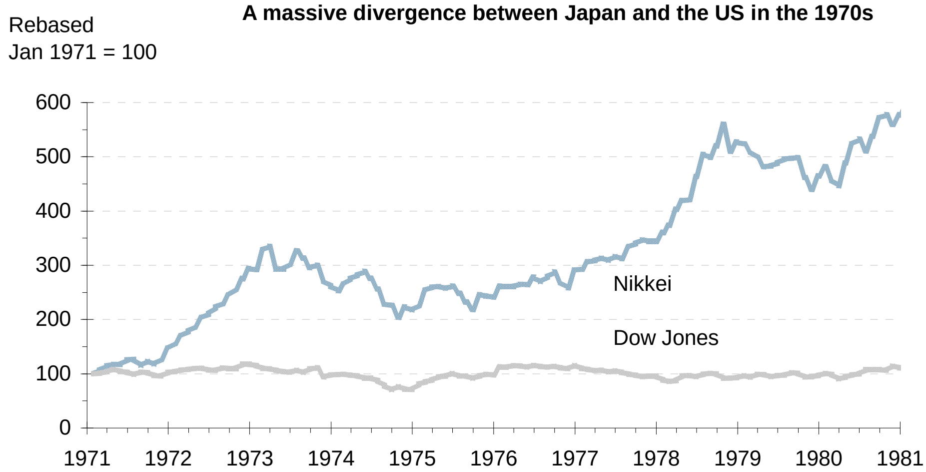


Source: MSCI

The conclusion is both opaque and clear. What happens in the near term is impossible to predict. Emerging economies, together with developed economies, are set to slow markedly in 2009. Consensus numbers are still far too high. I was in Guangzhou, the workshop of southern China, last month, where 20 factories are said to be closing each day and the economy may grow at 5% rather than 8-9% next year. But it's still 5%. And once markets return to anything resembling stability, the picture is very clear. Current market volatility surely offers a remarkable opportunity to position portfolios to take advantage of this.

Decoupling has happened before, to dramatic effect. The last great market to emerge was Japan. This coincided with massive outperformance of the Japanese market during the 1960s and 1970s. In the decade from 1971, the US market went sideways for ten years, while Japan rose sixfold!

A massive divergence between Japan and the US in the 1970s



Source: Bloomberg

A world dominated once again by China and India, with Europe and the US in important, but secondary roles, will be a different, and for some, an unsettling place. But perhaps not a bad one in which, instead of the West selling Asians opium, they are selling us toys, software and running shoes.

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