Time to embrace the concept of investable markets – not emerging markets

The Asian crisis of 1997-98 marked an inflection point for the debt-supported growth of Asia's Tiger economies. When Asian demand collapsed, a window opened for the non-inflationary growth in the western world. As Asia cut consumption and paid down debt, the West, led by the U.S., was able to maintain very low interest rates, which sowed the seeds for the past decade of debt-financed U.S. consumer spending.

The U.S.-led credit crisis is another inflection point. It's important for investors to understand both the investment risks and opportunities. Those who lack the appropriate historical and global background for interpreting the nature of the credit boom and bust over the past decade risk drawing the wrong conclusions from recent events and failing to understand where the global economy is headed.

The global economy has for some time been undergoing profound structural shifts. This has been driven by the combination of technology, which has significantly affected traditional business practices, and the rise of China, India and Brazil as important economic players on the global stage. In 2010, China will surpass Japan and become the world's second-largest economy after the U.S.

The credit bust has not changed the long-term drivers, but it has served to accelerate the shift to a new global economic order. On the global stage, recognition of the new world order is reflected in the recent and rapid rise of the G20 countries as the pre-eminent forum for addressing global economic challenges. Emerging countries now account for one-third of the global economy and almost all of its growth. Investors should move beyond a U.S.-centric view of the world and adopt a global perspective that recognizes these dramatic economic shifts and the rising influence of emerging economies. A good start would be to abandon the term emerging markets and embrace the concept of investable markets.

Globalization Phase II

In the March 2008 Signature Report, "The Global Economy at a Turning Point," we wrote about the increasing role of emerging economies and the need to rebalance the global economy: "The current U.S. credit crisis is triggering a dramatic shift in global economic relationships by accelerating the time in which the global economy will transition from Phase 1 of globalization, in which manufacturing shifted to China, to Phase 2, where emerging market consumers must step onto the global stage as U.S. consumption slows. This transition is an ongoing process that was occurring regardless. The condensed time frame, however, increases the risk of policy errors and economic instability."

The failure of Lehman Brothers was a policy error, but after a year of significant instability, we are starting to return to pre-Lehman economic conditions. What has changed as a result of the crisis, and what trends will now resume? In order to understand the recent past and the current outlook, it's necessary to distinguish between events tied to the economic collapse and the credit cycle, and those related to a traditional business cycle. Unlike most recessions, this resulted from a credit cycle and not a business cycle. The degree to which the downturn spread globally last year was related to the collapse in credit – not to the downturn in the U.S. economy. Credit is the oxygen of the economy. When it imploded last year, even healthy economies were hit hard and fast. When LIBOR soared in the fall of 2008, banks around the world refused to lend to each other for fear of who might fail next. An immediate unforeseen consequence was the evaporation of trade finance, essentially a form of medium-term interbank lending, which resulted in collapsing exports, industrial production and economic growth in every country involved in global trade. China, as the workshop of the world, saw tens of thousands of factory closures. The globally synchronized collapse underscored the interconnectedness of today's world economy.

In the wake of the massive and unprecedented policy response to restore global markets, credit has been creeping back. As it does, countries, companies or markets that were otherwise healthy are now springing back to life. Countries or companies that were previously unhealthy or over-levered are back to rebalancing and restoring their balance sheets. Some will not recover, but for most, the return of functioning credit markets allows them to address their issues with a newfound sense of urgency. Individuals, corporations and policymakers will de-lever and shift to lower, more sustainable debt levels. For healthy companies this process will occur rapidly. The record level of global debt, equity issuance and M&A activity this year are signs of balance sheet restructuring and assets shifting from weak to strong hands. At Signature, we have already participated in several such recapitalizations and will continue to do so on behalf of our investors. For governments, the process will be drawn out. They have used their balance sheets to absorb the impact of the crisis – leaving record-level deficits that will place higher claims on taxpayers, slow future economic growth and leave much of the developed world vulnerable to another crisis. The rebalancing of the global economy that had barely begun before Lehman Brothers collapsed must now recommence with even more urgency. A stronger global economy with weaker developed economies is the only way for the West to return to a stable economic footing without catastrophic results. But it will be a slow process.

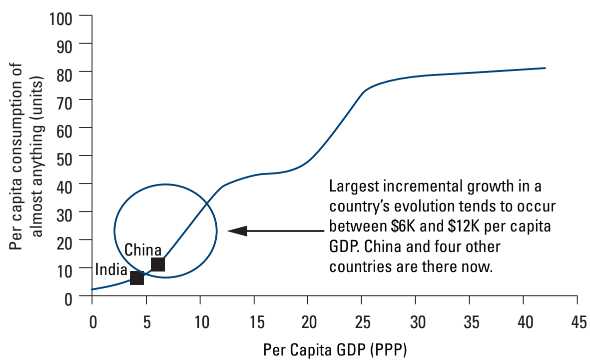
Two misconceptions about the global economy

In the current environment, two misconceptions about the global economy must be addressed. First is that the global economy – and China in particular – is completely dependent upon U.S. consumers. The second is that emerging markets are riskier than developed markets.

The U.S. is the largest consumer market in the world. According to Credit Suisse, in 2009 it will account for 28.3% of global consumption. That compares to 8% for China and 15.5% for all of Asia, excluding Japan. During the next five years, Asia (ex-Japan) will surpass the U.S., and China alone will account for 16.4% compared to 23.5% for the U.S. The trend is clear. While the U.S. may be the largest market today, Asia – led by China – has become a rapidly growing consumer market. China is already the largest consumer for many items, including cars, cell phones, and the Internet. But it has only just crossed the real income threshold where consumption of most consumer goods tends to accelerate. Historically, as an economy reaches an income of US$6,000 per capita, consumer spending accelerates significantly and continues to do so through to about US$12,000 per capita (see Chart 1). This was the case for developed markets, including the U.S. and Japan, as well as most developed markets across Asia. This development has always been accompanied by a surge in consumer credit, as shown in Table 1. China has just entered this zone and it is 15 times larger now than Japan was in the mid-1970s when it entered this phase.

A falling savings rate and rising use of leverage by Asian consumers will help offset a de-leveraging U.S. consumer.

Standard S-Curve pattern of consumption growth



Source: IMF, Nomura Research

Chart 1: Consumer spending in an economy tends to accelerate when per capita GDP its US$6,000. China has just passed this point, and is proceeding at the same pace as Japan in the mid-1970s. However, it's important to note that China's total GDP is already 15 times larger than Japan's was at the time.

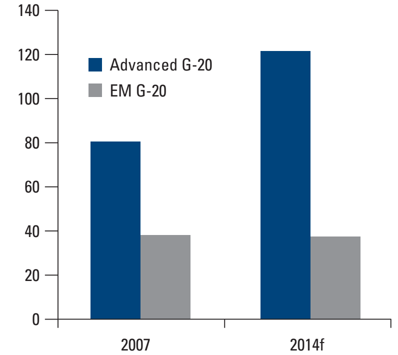
Many countries have seen this boom before

Country	Year	Growth in consumption (%) 2 years out	Growth in consumer credit (%) 2 years out
US	1972	20	31
Japan	1977	22	74
UK	1978	38	52
Hong Kong	1980	39	46
Singapore	1982	15	37
Taiwan	1985	22	40
Korea	1989	45	82
Malaysia	1993	31	56
Average		29	52

Source: IMF, CEIC, Bloomberg, Nomura Research

Table 1: This shows the year that countries hit the US$6,000 per capita income level and how consumption and credit grew in the subsequent two years. On average, credit grew by more than 50%. China has just reached the US$6,000 per capital GDP level and is likely to follow a similar pattern.

Who's more likely to default – advanced or emerging economies?



Source: IMP World Economic Outlook - 2014 is IMF projection

Chart 2: In the next five years, the average debt-to-GDP ratio of the developed nations within the G20 is projected to rise to over 120% from about 80% in 2007. Over the same time, the debt levels of the emerging countries in the G20 will remain below 40%. Developed countries have used their balance sheets to absorb the impact of the crisis. This suggests investors should reconsider their view of emerging markets as being riskier than their developed counterparts.

Just as the Asian crisis ushered in a period of non-inflationary growth in the West, slow demand from G7 countries will open a window to lower inflationary growth for emerging economies, which have spent the past decade rebuilding savings and paying down debt. Low interest rates and growing access to consumer finance will lead to a period of robust consumer-led growth in emerging economies such as China and Brazil. This will be the defining economic driver of the global economy in the coming decade.

Having just returned from visiting many Chinese consumer-related companies, I can attest that the transition has already begun. Contrary to perceptions in the West, I believe the rise in Chinese consumption has little to do with the need to build a social safety net and everything to do with demographics and surging confidence that the future is bright. With 43% of the population under 30, China's consumption growth will be driven by young adults in their mid-20s to mid-30s. In recent discussions with several in this age group, it was clear that they are not the source of savings within the country. Similar to young adults in the West, they have aspirations for a better life and are subjected to advertising and other pressures to spend, just like their global counterparts. They are already consumers and are not worrying about social security, health care and the like.

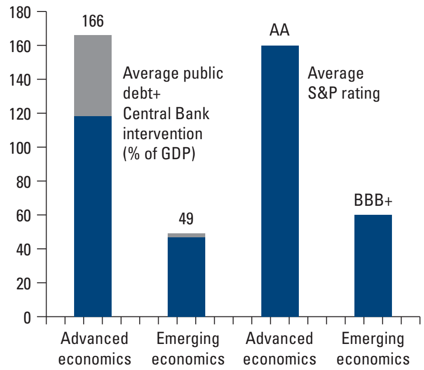
However, unlike in the West, where average incomes have been stagnant for the last 10 years, Chinese real incomes have been rising by 10% a year for over a decade.

Young Chinese have every reason to believe tomorrow will be a better day and are spending accordingly. With China leading the global economy out of recession, domestic confidence has never been higher. In addition, the policy of one child per family means that most young people are an only child. Many parents and grandparents are only too happy to lend money to these youngsters to help them buy their first apartment or car. The older generations will not change their spending patterns. Just as those in the West who grew up during the Depression were thriftier than the baby boomers, those who survived the Cultural Revolution are unlikely to change. Today's young Chinese will likely spend the savings of three generations over the next 10-20 years.

Are emerging markets more risky?

Secondly, the concept that emerging markets are more risky needs to be refined. I would argue that highly indebted countries are riskier, and that over the past 30 years the highly indebted nations have tended to be emerging markets. Excessive borrowing left countries exposed to an

Difference in public-sector debt levels is stark



Source: IMF, Bloomberg, S&P, Nomura Research

Chart 3: The difference in expected debt levels for the public sector in the developed and emerging world is stark. In the developed world, public debt and potential central bank liabilities currently account for 166% of GDP. In the emerging world, total public sector liabilities are 49% of GDP – 70% less than the developed world. Despite this, the advanced economies have much better debt ratings.

ongoing series of crises and their balance sheets were unable to cope. That is no longer the case. Today, risk lies squarely with the G7 economies, while many of the largest emerging economies have significantly lower debt levels. As shown in Chart 2, over the next five years the average debt-to-GDP ratio of the G20 developed nations is projected to rise to over 120%, from about 80% in 2007. Over the same time, the debt levels of the emerging countries in the G20 are expected to remain below 40%. This is a stark divergence. A similar analysis in Chart 3 shows the total actual and potential debt of advanced and emerging economies and their average Standard & Poor's rating. Something has to give!

If balance sheet weakness makes a company or country more susceptible to crisis, than many of the G7 countries may deserve a higher risk premium, while several key emerging market countries should earn a lower risk premium. While there are many other sources of risk in emerging countries, such as weak corporate governance and legal systems, the shift in relative fiscal strength will impact investment opportunities and returns in coming years.

Today, valuations in emerging markets are on par with those in the U.S. At Signature, we expect future global economic growth to be disproportionately driven by the emerging world as the West slowly de-levers. Slow growth and low interest rates and investment returns in the West will see capital flowing to markets around the globe in search of higher returns. This trend has already begun and we believe it will continue, as it did in 1993 when emerging market valuations soared well beyond those of developed economies. At that time, the relatively small emerging markets were unable to absorb global portfolio inflows and markets subsequently collapsed. Today's emerging markets are vastly larger and many already rival most developed country markets in terms of size and liquidity. Many countries are encouraging IPOs to deepen their equity and bond markets in order to attract global capital and expertise and help build their physical and financial infrastructure. While they will try to avoid the liquidity-driven boom-bust cycles of the past, the relative attractiveness of their growing economies will continue to attract strong global inflows and risk inflating the next emerging market bubble.

At Signature, we will continue to watch these developments unfold and position our funds to take advantage of these new investment opportunities. In Canada, the implications for our resource sectors and currency are profound – and will be for several years. In other sectors such as consumer products, financials, technology and industrials, we want to understand how corporate managements have positioned their companies to benefit from the opportunities in these markets, or to protect themselves from the threat of new competitors and slower domestic growth. Increasingly, we will also need to invest closer to the sources of growth. In recent months, our portfolio managers have travelled to emerging markets such as China, Taiwan, Brazil, Turkey, Mexico and Eastern Europe looking to build relationships with key players and corporate managements. As the range of investable markets expands to encompass many of today's emerging economies, Signature Global Advisors will be there.

Drummond Brodeur
Portfolio Manager
Signature Global Advisors

Global experience and expertise

Signature Global Advisors is one of Canada's premier investment management teams, with a strong track record and approximately $23 billion under management. Signature's expertise continues to receive industry recognition.

Two Signature funds were recipients of Canadian Investment Awards for 2008. **Signature Income & Growth Fund**, managed by Eric Bushell and James Dutkiewicz, was the winner in the global balanced fund category. **Signature Canadian Resource Fund**, managed by Scott Vali, was the top natural resources fund. Signature funds have now won an impressive six Canadian Investment Awards since 2001.

Mr. Bushell, Signature's Chief Investment Officer, also has been named Fund Manager of the Year by *Investment Executive* newspaper. *Investment Executive* made the selection based on a 10-year performance record that takes into account absolute and relative returns and other factors to identify consistent outperformance over the period. Mr. Bushell was selected based on the performance of Signature Select Canadian Fund, which he has managed since its inception in May 1998.

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