



Signature Report

The global economy at a turning point: Can emerging markets make the change?

Emerging economies are having a profound influence on the structure of the global economy.

Today, emerging economies, including the Middle East, have become the world's largest economic group at roughly 30% of global GDP, versus 25% for the United States. With their significantly stronger growth rates, they have become the key driver of the global economy, accounting for almost half of global GDP growth last year (See Chart 1). Emerging markets have become the price setter for most tradeable goods, commodities and factors of production – helping to explain why oil, agricultural and other commodity prices continue to rise even as the U.S. slips into recession (See Chart 2).

However, 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. It also requires investors to grasp the changing investment implications sooner rather than later. Ready or not, the global economy rests at an important inflection point.

Phase 1 – A Golden Period

The first phase of globalization started with China's acceptance into the World Trade Organization in December 2001, which speeded up its re-integration into the world economy. China quickly emerged as the workshop of the world as multinational corporations shifted global supply chains into

the country and China aggressively built out its infrastructure to accommodate the rapid industrialization.

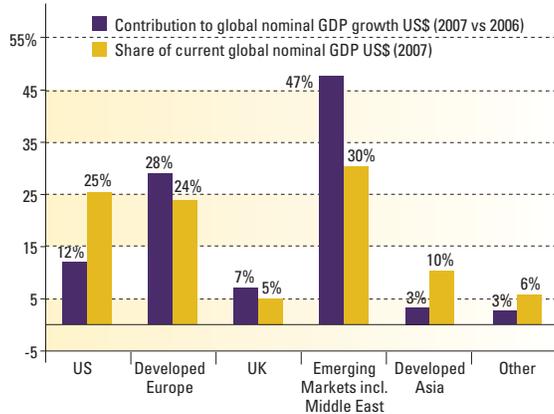
The years 2002-2006 were in many ways a golden period for the global economy. The shifting of manufacturing capacity to low-cost countries such as China lowered prices of manufactured goods in developed countries, kept inflation subdued and thereby kept interest rates low and real wages and income strong. At the same time, it fuelled China's economic growth, creating jobs and lifting more people out of absolute poverty than at any time in history. China's economy grew over threefold from US\$1.3 trillion in 2001 to an estimated US\$4.1 trillion in 2008. It will soon overtake Japan as the world's second-largest economy.

While we focus on the U.S. and China as the largest representatives of the developed and developing economies, this is not just about them. China's success with market-friendly economic policies has encouraged other developing countries to follow suit, including India, the world's second-most populous country, where economic growth has accelerated dramatically since 2003. The impact of strong commodity and energy prices has also powered growth and current account surpluses in a range of emerging economies, such as Brazil, Russia, the Middle East and even parts of Africa.

For years, this system worked to everyone's advantage. China produced goods and the U.S. consumed them. To keep its exports competitive, China pegged its currency to the U.S. dollar, forcing China's central bank to recycle growing current account surpluses and savings back to the United States by buying U.S. treasuries. In effect, China's workers were providing vendor financing to American consumers!

Emerging Markets are Driving the Bus

Emerging markets (including the Middle East) now represent the largest economic bloc globally



Source: IMP, Morgan Stanley Research

Chart 1: Emerging Markets accounted for almost a third of the world's economy and almost half of its growth in 2007.

Phase 2 – An Inflationary Shock

The U.S. credit crisis signals that Phase 1 is over and the world is shifting to “Globalization Phase 2.” This phase is about China and other emerging markets becoming self-sustaining economies that are increasingly dependent on domestic consumption and less dependent on exports destined for U.S. consumers. In other words, can emerging market economies decouple from the U.S.?

We believe it has already happened. China's economic growth has increased despite the American slowdown. Whether this divergence can continue in the face of the worsening U.S. credit crunch and rising domestic inflation remains uncertain, but first quarter data out of China continue to show no sign of a slowdown.

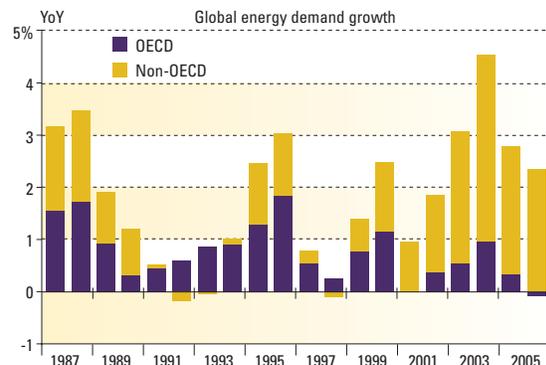
Simplistically, Phase 1 can be seen as a massive global supply shock. China's surplus labour entered the global workforce to produce goods for the developed world, significantly increasing global output capacity (See Table 1). For the developed economies, it was a relatively benign shock, with the only significant demand impact coming

through rising commodity prices, a result of China building up its industrial infrastructure.

Phase 2, which will not be so benign, is about the rise of China's middle class consumers. Now, the Chinese will be consuming more of their earnings and saving less. In effect, this is a global demand shock. With no offsetting increase in supply (as in Phase 1), China's demand will push up prices, forcing a reduction in demand elsewhere. In other words, Chinese consumers will be competing with U.S. consumers. The key difference is that the Phase 1 supply shock was deflationary, while the demand shock from Phase 2 will be inflationary. The rules of the game are changing!

The coming shift in the relationship between emerging and developed markets will have significant implications for the global economy and for investors. Emerging economies are shifting from exporting deflation to exporting inflation (See Chart 3). The current period of transition will remain volatile and fraught with risks of policy errors and rising protectionist behaviour. While we expect the transition to a new longer-term economic growth phase led by emerging economies will occur, it is not a foregone conclusion.

Incremental demand for commodities in recent years has been from emerging, not developed, markets



Source: BP Statistics, Merrill Lynch Commodity Research

Chart 2: Emerging markets, not developed countries, have been responsible for the increases in demand for energy and other commodities, which has been the key reason why commodity prices remain strong even as the U.S. economy slows.



Risks and Challenges

Ultimately, we expect strong domestic demand growth in the emerging economies to offset slowing growth from the U.S. and, to a lesser degree, Europe. Thankfully, the global economy has never been better positioned to withstand the deflationary impact of the U.S. credit crisis. In many ways, the coming two years will be the inverse of the 1997-98 Asian crisis. At that time, the collapse in domestic demand across Asia was offset by strong U.S. growth that allowed Asian economies to rebuild balance sheets on the back of robust exports. Now, the U.S. economy will need to rely on exports to a strong global economy, as American consumers reduce spending and increase savings to rebuild their balance sheets. The secular trend we must grasp is that Asia is at the beginning of a new asset reflation cycle, while the U.S. has entered an asset deflation cycle. The U.S. today needs China more than ever if it wishes to avoid a severe and prolonged economic contraction.

However, many emerging markets, including China, face their own internal economic and policy challenges, as worsening inflation may force tighter monetary policy, higher interest rates and slower growth. There are no easy solutions. To date, most of China's inflation has been led by food price increases that can not be resolved through traditional monetary policy tightening, but can threaten to broaden into rising inflationary expectations. Furthermore, with food accounting for up to a third of the consumer price index in many emerging countries, inflation does inflict significant hardships on lower-income urban populations. This has already sparked social unrest in countries such as China, Mexico and Egypt.

Allowing China's currency to rise faster can help to ease inflationary pressures and is a necessary part of the solution. But to do so too quickly would threaten significant layoffs in the export sector, which is already under significant pressure from a slowing global economy and rapidly rising wage and input costs. Rising currencies are also the route by which many emerging economies will start to export their inflation to the developed world, threatening to undermine central bank efforts to ease monetary policy.

China leads global labour supply

Labour supply (mn)			
Year	Global	Asia	China
1980	218.7	66.1	24.7
1990	326.0	187.6	108.7
2000	609.9	339.5	171.3
2006	862.2	524.2	316.5

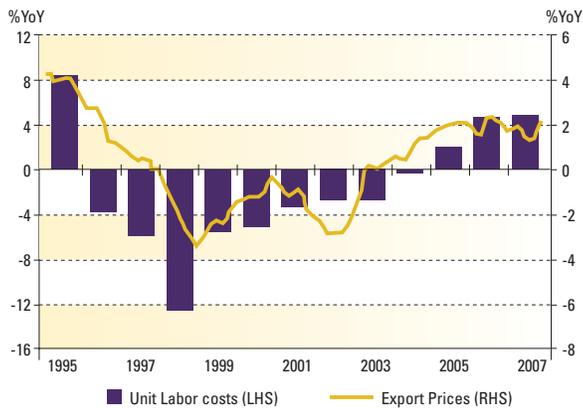
Source: IMF, CEIC, Merrill Lynch estimates

Table 1: China contributed 37% of the global workforce in 2006, and accounted for almost 60% of the increase in the global labour supply from 2000-2006

Investment Implications

- In a credit crisis, buy the creditors – We don't mean banks; today, the creditors are the countries with current account surpluses and underleveraged balance sheets at the consumer, corporate and country levels.
- Energy and resources – There will be dips as the U.S. recession should trigger fears of a greater global slowdown, but commodity prices remain supported by the structural drivers of industrialization and urbanization in emerging economies.
- Agricultural plays – Increasing numbers of consumers in the world's two most populous nations can now afford an enriched diet that includes more meat, dairy, fruits and vegetables. This has already reduced many global food stockpiles to 30-year lows, so the inventory cushion is gone.
- Inflation is back – When the U.S. economy climbs out of recession, expect central banks to shift rapidly into inflation-fighting mode. Once again, beware of leveraged balance sheets and focus on companies that are able to pass on price increases to customers.
- Beware of interest-sensitive securities – With U.S. government yields pushing 40-year lows and inflation already visible on the horizon, the time is approaching to step further out the risk curve.

China already exporting inflation



Source: BP Statistics, Merrill Lynch Commodity Research

Chart 3: Many emerging markets such as China are beginning to experience rising inflation, which they are "exporting" to other nations through higher prices for their goods

- Alternative energy – In an environment of elevated fuel prices, previously uneconomic energy sources are becoming profitable. This is likely to remain the fastest-growing sub-sector of the energy market. Demand will come from emerging as well as developed markets, as China cannot achieve a Western standard of living off a carbon-based energy infrastructure.
- Infrastructure – Countries from China to India and the Middle East are all embarking on aggressive infrastructure programs following decades of under-investment. Asia is expected to spend over US\$3 trillion on infrastructure in the coming five years, and, if economic growth slows more than expected because of the U.S. downturn, governments will likely increase infrastructure spending to support employment.
- The emerging middle class – Watch for those consumer brands that are tapping into the explosive growth of the spending of the emerging upper middle class throughout the developing world. Modern retailers, tourism, and medical and educational services are all areas where Asia's new middle class will be spending its savings.

At Signature, we incorporate our global views into every investment decision. Our current defensive positioning reflects our expectations of an increasing global growth scare impacting asset prices. As prices correct to reflect this risk, we will look to increase our exposure to companies and markets that will benefit from the next phase of globalization – a phase that will be dominated by scarcity, as China's scarcity becomes the world's scarcity. The laws of economics clearly demonstrate that rising demand, other things being equal, will be met with rising prices. We are about to discover whether our world's finite resources can support a middle class lifestyle for an additional one billion people in the developing world. This will affect the relative performance of all asset classes globally.

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