

Underlying dynamics of the global economy – the backdrop to the global equity markets

For our first Thought Piece we felt we should start the series by telling a story about how the world, its economy and financial markets got to where they are today. Of course there are many stories around on this idea. Each has its own take, its own heroes and villains, or to be less melodramatic, drivers and critical junctures. This is just one take.

Five Oceans also wants you to note that this piece is a synthesis of many macroeconomic views. Whilst at Five Oceans we have views on these matters, it is not the basis of where we think we add value. It is a backdrop to our primary focus, which is industry and company-specific research. The background that we all know about.

It is with some reluctance that we must build the argument by acknowledging the profound, if not ubiquitous, operation of those key drivers on the world stage, so discussed by us all.

Globalisation and the IT revolution – the primary driver of profit growth

The IT revolution was born of a collection of elements; Moore's Law relating to the exponential improvement in processing power, a telecommunication network made so much more powerful by a massive expansion in capacity facilitated by photonics and data compression connecting those processors, and the organising principle of the internet.

... Leads to leap in productivity

Past industrial 'revolutions' were marked by the application of new technologies', the steam engine and electrical power to the manufacture of goods, and the steam engine and the combustion engine to the transport of those goods. The IT revolution represented the application of new processes to the organisation and communication of information. By enabling the instantaneous transmission of commercial information it has facilitated the reorganisation of both the underlying production process and the distribution system allowing access to those goods and services by the end user.

The operation of competitive forces has meant not only has it been possible to undertake this type of reorganisation, doing so has proved necessary to survival. To an extent dependent upon the degree of competitive pressure, production and distribution structures have been realigned to capture efficiency gains. The relationship between inventories of raw materials to finished

goods, and the organisation of the manufacturing process can be finely managed relative to end demand.

Globalisation

In the face of those competitive challenges, business has required both scale and access to low cost factor inputs, most specifically labour. That manufacturing process has then been linked to the distribution system by way of IT-based supply chain management systems.

The reorganisation of the manufacturing and logistics systems both permitted and required that resources were shifted across national borders. As such the consequences need to be understood also in geographic terms.

This has coincided with the rising socio-demographic imperative in China and India that the operation of their economies be significantly reformed in order that the demands of a growing population do not challenge the integrity of the respective nations, and the elites that drive them.

Both nations in their own way have adopted policies to link their economies into these global value chains. As such a huge cheap labour pool has been made available.

Note the changes in manufacturing as a percentage of GDP since 1970 in the below table for China, Thailand, Malaysia, Indonesia, Singapore and Korea versus the US and Japan.

Manufacturing as a percentage of GDP, selected years

| | 1970 | 1990 | 2004 |
|-------------|------|------|------|
| China | 36.7 | 40.0 | 41.8 |
| Thailand | 16.1 | 27.2 | 34.5 |
| Malaysia | 12.4 | 24.2 | 31.4 |
| Indonesia | 10.3 | 20.7 | 28.3 |
| Singapore | 17.9 | 25.8 | 27.1 |
| Korea | 16.2 | 24.5 | 25.5 |
| Taiwan | 29.2 | 33.3 | 25.5 |
| Philippines | 24.9 | 24.8 | 23.4 |
| Japan | n.a. | 26.7 | 20.5 |
| India | 12.6 | 16.6 | 17.4 |
| US | 24.0 | 17.9 | 13.0 |
| Hong Kong | n.a. | 16.1 | 3.4 |

Source: CEWIC, CLSA Asia-Pacific Markets

Corporate profitability in light of globalisation

Whilst competitive pressure has increased in many segments, a number of companies have managed to retain some of those advantages in terms of improved profitability. By and large the winners have been those companies with strong positions in distributing to end customers a quality product offered at a competitive price. Profits have accrued, as is always the way, to enterprises that have best availed themselves of the opportunities offered in the new environment.

Those opportunities have involved either the reorganisation of production and distribution in the most efficient manner possible across borders, or outsourcing activities that were previously undertaken internally by the enterprise. That outsourcing can reflect either the existence of low cost producers that possess efficiencies that cannot be readily matched, or, access to cheap funding that facilitates, rightly or wrongly, investment in capacity that is not required to generate the same level of return as that required by investments in the mature markets of the developed world.

These drivers, reorganisations or outsourcing, are now manifest in so many industries. One of the most commonly cited examples of these processes, to the extent that it now verges on cliché, is Dell Computer. Dell's re-engineering of its supply chain by outsourcing production and distribution has fundamentally altered the PC business model.

In another segment Wal-Mart re-engineered its supply chains back into China. It turned the traditional retail model on its head. No longer was Wal-Mart the passive recipient of goods originated by independent manufacturers. It increasingly integrated those manufacturers down its supply chain, across the globe into the needs of its retail franchise model.

Some of these strategies have been launched on the front foot to establish competitive advantage. Others have been necessary just to survive in tough industries. Philips has noted the difficulty in operating in the consumer electronics industry, whereby there is always a new entrant emerging in Asia, partially reliant on a plant that is not required to generate the same level of return that Philips is required to generate on new a plant. As such Philips has now virtually eliminated all manufacturing from its consumer electronics business.

Even the more successful proponents of this process, the initiators such as Dell, are now confronting increasing competitive challenges.

Generally companies that are still dependent on capital intensive manufacturing processes have broadly suffered under the increasingly competitive global environment.

It is interesting to note the geographic significance of this phenomenon. Processes that must operate within the ambit of an economy, manufacturing, distribution, and service, that historically located themselves under the umbrella of a single national economy, now find themselves located in different nations, connected by the operation not just of a global logistics systems, but facilitated by the operation of exchange rates and mobile financial capital. It is problematic to consider the Chinese economy as separate from the US or European economies, to the extent that significant portions of their manufacturing processes and fixed capital investment now take place in China.

We now face increasing difficulties in predicting the behaviour of developed economies such as the US. Economies which previously saw the bulk of functions housed within the national economy, such as manufacturing, now see these operating trans-nationally, i.e. globally. This creates increasing ambiguity re economic policy. For example, the transmission mechanism between central bank policy shifts and targeted economic variables, difficult to gauge even in traditional economies, become even more complex.

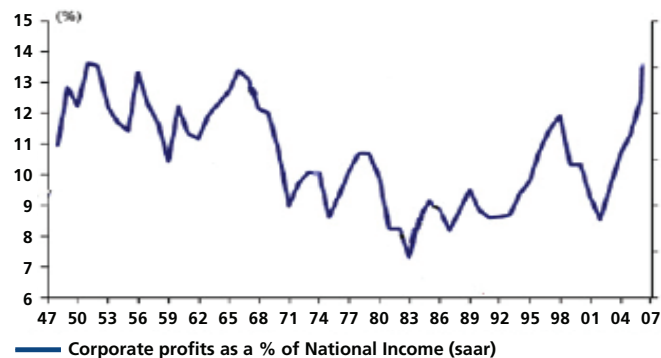
When discussing the evolution of profit shares, and returns on capital investment, we face similar questions. They need to be considered not just within a specific national economy, but across the global stage, not just for an individual company, but across the supply chain.

So whilst our understanding is that profit share is at historic cycle peaks in many developed economies, this level is in part facilitated by returns on capital below normal levels on certain other capacity in the supply chain, built in developing regions. Of course, part of that profit increase reflects the retention of part of productivity enhancements by companies.

The question is how far can this go? It may be that profit share has peaked as part of GDP? Or that in specific segments the expansion in both margins and returns on capital has now peaked?

In the below chart the line shows the lift in US corporate profitability, and productivity, that has occurred in part by virtue of the re-engineering of the supply chain, that has seen production move offshore to developing countries, in part by productivity driven by technological advances, and in part by monetary policy that will be discussed next.

US profit share



— Corporate profits as a % of National Income (saar)

Source: CEIC, CLSA Asia-Pacific Markets

Monetary policy – the secondary driver of profit growth

Technology and globalisation forces have put downward pressure on a range of prices, most noticeably of manufactured goods, but also in some instances certain services.

This disinflation drive is exemplified in the Wal-Mart retail chain which since its inception has elevated one goal above all others: cutting prices. This approach has wrung tens of billions of dollars in cost efficiencies out of the retail supply chain, passing the larger part of those savings onto consumers as bargain prices.

‘In 2002, New England Consulting estimated that Wal-Mart had saved its US customers US\$20 billion. To this one must add the price cuts having to be made by other retailers resulting in savings to the consumers of up to US\$100 billion. It is no wonder that economists refer to a broad ‘Wal-Mart effect’ that has suppressed inflation and rippled productivity gains through the economy year after year.’

Wal-Mart’s approach has an effect across much of the world economy given the importance of its business to developing countries.

The structural changes of globalisation have produced outcomes that have given an additional impetus to the creation of wealth, in part by way of their impact on inflation, and consequently on interest rates. These forces have been further accentuated by monetary policies in the developed world designed in part to facilitate the smooth transitioning of their mature economies in the face of this significant reallocation of resources away from old industries, whilst seeking to minimise deflationary pressure.

As such the world has witnessed low interest rates, relatively loose monetary policy, and growing levels of profitability in a number of parts of the corporate sector. This has created a boom in financial markets, financial engineering, asset inflation, and the profitability of those benefiting from such forces.

Important questions are raised by those monetary policy settings which are covered in another Thought Piece on Monetary Policy.

Lower global interest rates

Whilst it is unsurprising under the circumstances that nominal interest rates are lower given lower inflation, real rates have also been lower despite higher growth levels in a number of economies.

The fall in real rates is a reflection of a collection of factors.

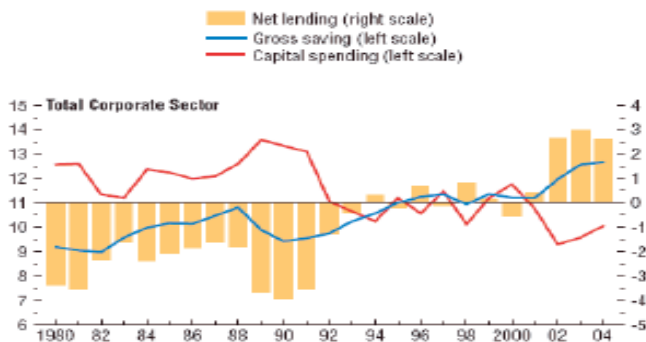
After the collapse of the net bubble and concerns about consumer confidence post Sept 11, the US Federal Reserve had further impetus to maintain an easy monetary policy setting. Japan was struggling with the extended consequences of the deflation that followed the boom of the late 80’s and early 90’s, and so too has been in the grips of extraordinarily loose monetary policy.

De-leveraging corporate balance sheets

At the same time the boost in profits afforded by efficiencies registered in the value chain have seen a de-leveraging of the balance sheets of many western companies. Refer Chart 2: G7 Corporate Sector Savings (% GDP), which shows the post tech bubble fall in corporate investment and the associated rise in corporate savings. Whilst profit shares are at cyclical highs in most economies, corporations have been more reticent in undertaking capital expenditure. Note that to the extent Net Lending in Chart 2 is a positive percentage of GDP then this refers to the funds supplied by the corporate sector to the economy (lent out as opposed to borrowed). This has in part reflected greater capital discipline and with technological advances, the ability to do more with less. It has also represented a lessening of capital intensity as manufacturing is outsourced to China and India, for example.

However in a number of instances there is something more. Maybe it is a fear of repeating the unprofitable capital expenditure at the peaks of previous cycles, the tech bubble of 2000-01 being the most recent example. But also there is evidence to suggest that a number of companies in seeking to flatter short-term profitability and consequent share price appreciation, have held back on a range of investments, ranging from traditional fixed asset formation, to marketing budgets in some instances.

G7 Corporate Sector Savings (%GDP)



Source IMF – excl Germany

For whatever reasons, many traditional companies find themselves with un-leveraged balance sheets. In other terms this phenomenon has been characterised as ‘surplus global savings’, relative to investment spending.

Notwithstanding this, we have seen over the last couple of years an increasing return to business investment by the corporates at a time when housing investment is slowing in the US and question marks over the continued strength of the consumer appear. Refer to the following chart.

Economy Has Been More Business Drive, Not Consumer Driven, Over The Past Two Years



Source: Bureau of Economic Analysis, Morgan Stanley Research.

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We now see a world economy founded on the information technology revolution and its facilitation of leaps in productivity and globalisation. This combined with the secondary driver, relatively loose monetary policy, has today given us a healthy global economy with low inflation, low interest rates and low unemployment.

However, how long will this last? Our current thinking is that:

1. World growth has probably been above the sustainable level, to a degree, but it is not clear whether that extent is within reasonable bounds and can be brought back through marginal policy shifts, and the free action of increasingly flexible global markets, or some greater shift/shock will be required/precipitated.
2. Interest rates and inflation rates will be higher than has been recent history, but where they will settle? Financial markets are still exploring the risk that notwithstanding inflation is back, growth may be slowing faster than is optimal, leading potentially to stagflation, thereby creating a major policy bind for Central Banks.

For more see our Thought Piece on Monetary Policy.

Notes

- ¹ http://en.wikipedia.org/wiki/Moore's_Law ‘Moore’s Law is the empirical observation that the complexity of integrated circuits, with respect to minimum component cost, doubles every 24 months. It is attributed to Gordon E. Moore, a co-founder of Intel. If Moore’s Law were applicable to the airline industry, a flight from New York to Paris in 1978 that cost \$900 and took seven hours, would now cost about \$0.01 and take less than one second.’
- ² Dell is an interesting case in point. From being the standard bearer of ‘asset-lite’ commercial structure its market share and profitability would now seem to have peaked in the face of competitors who have either imitated its manufacturing processes, or are offering superior end customer satisfaction in terms of product and service.
- ³ <http://www.wordspy.com/words/Wal-Marteffect.asp>
- ⁴ <http://www.wordspy.com/words/Wal-Marteffect.asp>