The Wealth of Nations

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The Wealth of Nations

The world is witnessing a major rebalancing of economic power. Once dominated by the G7 nations, it is today making room for a new and expanding set of rapidly growing economies. The citizens of emerging market countries, while comparatively poor on a per capita GDP basis, are being helped out of poverty by astounding rates of domestic economic growth. For some of the larger developing economies such as China and India, economic progress has catapulted them to a plane where they are able to compete side-by-side with the wealthiest and most advanced nations of the world.

In this paper, we explore the evolution of today’s economic growth through the lens of Adam Smith’s *An Inquiry into the Nature and Causes of the Wealth of Nations*, published in 1776. We examine the current post-Great Recession landscape, the intensifying competition from corporations domiciled in rapidly developing economies, the rise of the new global consumer, and the risks that exist in this increasingly interconnected, technology-based and information-driven world. Finally, we offer specific investment strategies that attempt to capture the benefits that are certain to come from a world continuing to rebalance its wealth of nations.

The Tale of Two Worlds: The Developed and Developing

What was once a world divided into developed and developing spheres is now one undergoing a revolutionary transformation. Gentrification on a global scale is helping to change the socio-economic profile. It is estimated that more than 70 million people, most of whom are citizens of emerging market countries, are rising into the middle class each year. A recent McKinsey & Company report projects that close to 40 percent of the world’s population will have achieved middle-class status by global standards by 2020, up from less than 20 percent today. This phenomenal rise in wealth is expected to bring onto the world stage a legion of global consumers with spending power on a scale never before seen.

On the other side of this transformation are debt-laden, relatively wealthy countries (including the United States) that are desperately grasping for economic growth, in effect trying to reclaim their past economic stature. In that effort, progress may well be hindered by a notable shift in demographics. By 2030, the National Intelligence Council expects the median age in Germany to be 49 years, 39 in the United States and 52 in Japan. This will have huge implications as these groups reach retirement age. Furthermore, as a result of their exploding debt levels, these historically dominant nations are now confronted with the behemoth task of slashing bloated government budgets amidst strong opposition. Citizens are protesting, sometimes violently, rejecting the notion that permanent austerity will solve their problems. The dilemma of how to resolve high deficits without suffering from stubbornly high unemployment, weak consumption and investments is stymieing progress.

Further challenges are exacerbated by the absence of leadership and consensus by policymakers worldwide on how to address this quandary. The lack of political will to resolve sovereign debt issues has culminated in episodes of political dysfunction, both in the U.S. and the Eurozone. This state of affairs has posed threats to government stability, making economic progress more fragile, less tenable and crisis-prone.

Intense Competition from Emerging Markets

Following the 2008-2009 financial crisis, the world’s hierarchy seemingly turned upside down. As recovery subsequently took hold, the economic gap between emerging market countries and their developed counterparts narrowed and the order of the largest economies was reshuffled. The most significant shift was China’s displacement of Japan as the world’s second largest economy in 2010. Such a development was unimaginable 20 years earlier when America viewed Japan as its primary competitive threat.

We reference an article on the topic from the August 17, 2010 *Wall Street Journal*:

“It’s worth pondering the reasons for this Asian reversal, and its implications. One obvious, if too often forgotten, lesson is that the wealth of a nation is not a birthright. Prosperity has to be earned year after year, through sound economic policies that unleash the natural talents of a nation’s people.”

Now the world is watching and speculating about when China might eclipse the United States as the world’s largest economy and the answer may be “sooner than you think.” According to International Monetary Fund (IMF) forecasts based on purchasing power parity, a measurement that attempts to level the purchasing power among the currencies of different countries, China could overtake the U.S. by as early as 2016.

The decoupling of resource-rich nations and emerging Asian economies from the U.S. and other developed markets is due
in part to changing global trade patterns. In 2010, Brazil, Russia, India and China (the BRIC countries) imported more goods than the U.S. for the first time ever, while World Trade Organization and World Bank data show that more than one-third of emerging market exports goes to other emerging markets.5

As shown in Charts 1 and 2, the economies of emerging and developing market countries were projected to grow at 5.5 percent in 2013 compared with an anemic 1.8 percent for advanced countries.6 Of the 10 largest economies in the world in 2012, four are in emerging countries.7 This two-tiered growth trajectory will continue to generate increasingly greater contributions to world output from emerging markets.

Rapid growth in emerging market locales is not only leaving rich countries behind but also making it harder for them to sustain growth, mostly due to intensifying competition for raw materials. The supply of commodities has struggled to keep up with the pace of increasing demand. The resulting imbalance in the commodity markets has pushed up prices,
taxing consumers and pressuring growth along the way. The IMF estimates that a 10 percent rise in oil prices shaves 0.2-0.3 percent from global GDP growth, but the impact on large oil consumers such as the U.S. could be twice as large.

While developed countries are looking for ways to stimulate growth, emerging countries are seeking measures to do the opposite. In Asia and Latin America, policymakers are raising interest rates in an effort to keep their economies from overheating. The Chinese are contending with an inflation rate that rose to a three-year high recently, although moderating since then to a still high six percent following a 25-basis-point hike in interest rates. India’s central bank also lifted rates to address an inflation rate of over 11 percent. Meanwhile, inflation in Brazil has been north of six percent.a To summarize, as central banks in developing countries continue to tighten monetary policy, some moderation in growth should begin to surface.

Long-Term Dollar Depreciation
In recent months, quantitative easing, higher interest rates in the Eurozone and slowing U.S. growth have all taken a toll on the value of the U.S. dollar. More germane and alarming, over an extended time frame, the greenback has been in steady decline, averaging 0.8 percent depreciation annually since 1973. Along with the relentless evolution of globalization, other countries have narrowed the lead that the U.S. once enjoyed in exports and economic growth and their currencies have accordingly benefitted. Moreover, the uncertainty surrounding the U.S. debt debate and the downgrade of U.S. debt securities by Standard & Poor’s have pushed the U.S. dollar to near-record lows. If the decline were to accelerate, inflation risks would likely rise commensurately.

Global Challengers versus Established Multinational Corporations
Intensifying competition is nowhere more apparent than in what now exists between corporations domiciled in rapidly developing economies and established multinational corporations (MNCs). Technology has improved the efficiency of transportation and communication, enabling greater trade participation across the world, thereby facilitating disaggregation of the production process globally. This phenomenon is helping to increase the number and importance of international businesses.

“Global challengers,” a term coined by the Boston Consulting Group (BCG), defines companies in developing nations that pose the greatest threat to the entrenched leadership of MNCs. BRIC companies now dominate the list of BCG’s 100 global challengers with 13 companies from Brazil, six from Russia, 20 from India and 33 from China with the balance spread widely across the globe. BCG projects that over the next five years, 50 additional global challengers could qualify for the Fortune Global 500, tripling their presence on the list today.

Furthermore, the global challengers’ revenue is projected to reach an aggregate $8 trillion by 2020, an amount that is roughly equivalent to what S&P 500 companies generate today. In the past decade, the upstarts have seen their revenues grow by an average of 18 percent annually, three times faster than those of non-financial firms in the S&P 500.a As competition intensifies, the world will surely see the lines between global challengers and established MNCs diminish further.

A New Class of Global Consumers
While developed-market consumers have become more frugal in recent years, those in emerging economies have been accelerating their spending (Chart 3). Growing trade and positive demographic trends in resource-rich countries and financially sound emerging Asian economies (those with excess cash and high disposable income as a result of fiscal surpluses) are giving rise to a more diversified, global consumer class. With over 80 percent of the world’s population in developing market locations, coupled with a growth rate three times faster than that of developed nations, this burgeoning global consumer class represents a formidable force. The IMF estimates that over the next five years, nearly 60 percent of new global growth will come from emerging economies.


We believe that this legion of consumers will be the key driver of global economic growth going forward, based on their sheer numbers (Chart 4), improving discretionary income and a voracious appetite for goods and services previously out of their reach. Annual consumption from this group is expected to grow by more than 300 percent by the end of the decade to about $20 trillion, twice that of the United States.10 According to the International Telecommunication Union (ITU), cell phone penetration in developing countries is currently 68 percent. Of 226 million
new Internet users in 2010, 162 million were estimated to be from developing countries. Even more impressive has been the volume of automobiles purchased in developing countries; in 2010, for example, sales were up 34 percent in India while the Chinese purchased 6.3 million more vehicles than Americans acquired for the year.

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This new class of global consumers represents a significant untapped market for businesses around the world. Those enterprises that are agile and supported by countries that facilitate trade-friendly policies will be best positioned to capture meaningful market share and grow with the wealthiest emerging nations. Fortifying this consumer demand will be the governments of these new global consumers. To support growth, significant sums will be invested to upgrade existing water, sewer, power and transportation systems.

A World of Risk
In addition to the currency risks referenced earlier, others will also affect the future growth of the worldwide economy and the global challengers. Growth itself will precipitate a shortage of natural resources, produce supply disruptions and ultimately put pressure on prices. In the years ahead, energy, agriculture and precious metals likely will continue to face supply constraints, pushing prices higher unless alternative resources, methods and processes are developed. Furthermore, while this new world of greater interdependence between trading countries has created tremendous opportunities for investors, entrepreneurs and corporations alike, the complexity of today’s markets makes them vulnerable to systemic failures. Counterparty risks are all the more likely, particularly with foreign investments. Fierce competition in world trade could also pose a threat that protectionist policies will be heightened. These and other barriers could disrupt the flow of exports and reduce growth expectations. Finally, technology and communications have facilitated greater transparency and made the discovery of new information almost instantaneous. This has resulted and will continue to result in the number of these potential risks increasing in frequency and magnitude.

Global market volatility in reaction to the European debt crisis illustrates the new types of risks extant in a world that has become more interconnected than ever. While risk controls were widely implemented following the financial crisis of 2008–2009 and the system is self-correcting in some aspects, there have been some unanticipated, highly impactful events that have occurred and will almost certainly recur in the future.

Any destabilizing event, such as an escalation of the Eurozone crisis, could send shockwaves through the global economy, possibly pushing developed economies back into recession. Until now, emerging market countries have been largely insulated from the uncertainties within the developed markets. However, as events of the 2008–2009 financial crisis demonstrated, it is clearly possible, if not probable, that there may be other times when severe drops in worldwide securities markets leave no place to hide.

Investment Implications
- In the U.S. and other developed markets, a painful debt reduction process is underway making it likely that growth will be muted in these regions for some time to come. Going forward, we believe that growth will be driven by emerging economies with rising consumer classes – such as those in China and India – where population demographics are contributing to an economic transformation.
- With regard to currencies, international investments offer an effective hedge against the risk of further deterioration in the value of the U.S. dollar. Exposure to foreign currencies within a portfolio also provides additional diversification and reduces the overall risk profile as well.
- International investments can offer boundless opportunities for gains. Given the muted growth prospects we expect domestically, U.S. investors should think of themselves as global investors living in the United States. They should consider a sizable allocation (relative to their risk tolerance and financial goals) to international markets across all four asset classes.
- As millions of people move into the burgeoning consumer class, they will help to fuel economic growth. Their demands are anticipated to be similar to middle-class consumers in developed nations. This will precipitate pressure on commodity prices, foster technological...
innovation and give rise to large-scale infrastructure projects around the world.

Deregulation, the lowering of trade barriers and expanding foreign investment have fostered more open markets and opportunities previously unknown or inaccessible. The development of financial securities such as ETFs has made it easy and cost-efficient to invest in precious metals, international equities and bonds, emerging markets, options strategies and long and short strategies, to name just a few. Additionally, the proliferation of niche products from alternative asset managers has given investors more choices than ever for investing in some of the fastest growing regions of the world.

Conclusion
We suggest that investors maintain or establish exposure to emerging market equities and commodities, and maintain full positions in U.S. large-cap equities which stand to benefit from a declining dollar and the rising wealth of other nations. A world of investment opportunities exists, both here and abroad.

Nonetheless, prudence calls for the recognition of risk and its impact on an investment portfolio. While there are few actions that can be taken to mitigate the damages from a protracted collapse in economies and markets (as most asset classes tend to move together during these events), investors can take steps to buffer the impact in the event the unexpected happens. Specifically, they can avoid being forced to liquidate assets in an irrational market. One way to manage the emotional distress caused by extreme market volatility is to retain enough cash to fund 6-18 months of living expenses. Having such a safety net available can help investors stay engaged in the markets with the remainder of their assets and confidently embrace their long-term plan, even in times of severe volatility and turmoil.

In conclusion, we encourage clients to work with their Abbot Downing team to develop an investment plan that participates fully in the global growth prospects that will likely materialize in the next decade and beyond.

Endnotes
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4 International Monetary Fund, April 2011
5 World Economic Outlook, International Monetary Fund, January 2013
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