May 18, 2012

Dear clients and colleagues,

The last few weeks have been difficult for investors. Equity markets, following their best first quarter in years, have now surrendered most of those gains and in deep negative territory in Europe.

We were expecting some uncertainty following the elections in France and Greece. However*, we believe that this latest correction brings us close to a secular shift in sentiment and we are about to embark on a new secular bull market for equities. Why?*

The missing piece in the global growth story for the past few years was the rise of the consumer in emerging markets. Over 1 billion new middle class consumers. Although global growth was impressive in the period prior to the global financial crisis (GFC) of 2008, much of that growth was led by a massive investment cycle by itself unsustainable and with many negative consequences such as over-leverage and inflation. In its 12th five-year plan, China had made a shift to a consumption-led economy a priority. By consumption, we are not just taking the consumption of goods; services are an even bigger part of most developed economies. The good news in China is that we are getting close to a much more balanced economy. In its latest GDP growth number, China reported growth slightly above 8%. Although slightly below expectations, which disappointed markets, it was right in line with the goals of China's policy makers. What was important to note about that growth number was that over 75% of it came from consumption. China's economy is no longer only dependent on investment or exports.

If we look to the United States, we find that the US economy is recovering. An uneven recovery, to be sure, but with major industries such as housing and automobile at depressed levels, we are confident that the recovery will continue and, better yet, without the excess of the last boom. Yes, the US government has to tackle its deficit and its debt which markets surely will soon start to worry about, but the better way to solve the problem is increased revenues. Already, many States are showing much improved finances, thanks to rising corporate profits and lower unemployment.

Certain emerging markets are vulnerable. But countries such as Indonesia and Vietnam have been on a rising trend since their own financial crisis in 1997 and sailed through the GFC without much damage. Brazil is also in good shape and should experience strong growth leading to the World Cup in 2014 and Olympics in 2016.

Europe's problems are well known, but we believe its positive attributes and the fact that it is China's, Brazil's and other emerging markets' main trading partner is often underestimated.

It is very rare to see all regions of the World grow at the same time; this has happened in only two periods since 1945: the early 50s and the few years pre GFC. So, although Europe will contract this year, we expect global growth to be around 4%, about the same as the average over the past 30 years.

We recently returned from a trip to Hong Kong and Macau. A full day was spent meeting with economists, political analysts and strategists to discuss China. Our conclusion is that China has made much progress in the last few years to better balance its economy. Major reforms are well underway in most areas from healthcare to housing to financial markets and intellectual property. This is already leading to more balanced growth. There are still important problems or challenges such as corruption and the over influence of state-owned enterprises. But there is increased awareness of these problems and just the fact that they are openly talked about is a positive.

The latest set of economic numbers out of China has been mixed but generally positive. In our China comment of March 30th (see our archives), we shared our thoughts that the Chinese economic slowdown would end with Q1. We still believe that and growth in the second half of this year may even surprise on the upside.

A few data points to support our view. Car sales were up 12% y-o-y in April, the strongest growth in almost 2 years. Shippers are demanding a $600 surcharge to ship a 40 foot container from Asia to the US this summer, the highest since 2007. Macau received 28 million visitors in 2011, 58% from mainland China, a 25% increase over 2010. Hong Kong received 41 million visitors from mainland China in 2011 and we expect those numbers to increase in 2012.

Chinese wages rose in excess of 10% in 2011. With inflation at 4%; it means a rise in purchasing power. That explains the continued strength in retail sales, up over 15% last year and with no sign of slowing down this year.

We met over 30 companies at the conference. The overall tone was positive albeit more cautious than last year. A positive is that many companies are not just focusing on growth but on profitable growth and the need to create shareholder value. We met a few of our holdings such as Stella International (1836 HK), a leading shoe ODM (Original Design Manufacturer) and emerging shoe retailer. We had the opportunity to challenge the company on the issue of rising wages, high employee turnover and other challenges facing them and many other Chinese manufacturers.

Their answers mirror those of other Chinese companies. To counter rising labor costs, companies are moving to interior provinces of China and some are opening plants in Vietnam, Malaysia or Indonesia. Many are also automating factories; you may read our comment of May 4th.

It is important to look at the total cost of goods sold when assessing competitiveness, but also quality, reliability and turnaround time. Labor is often less than 20% of the total cost of goods sold.

Chinese companies are well aware of the risks of global competition and we do not foresee a rapid decline of their dominant position forecast by others.

Have a good weekend.

The Global Alpha Team