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GLOBAL FINANCIAL MARKETS PERSPECTIVE

THIRD QUARTER 2009

THE RETURN OF GLOBAL GROWTH

Every few decades, a seismic shift occurs in the world economy that has far-reaching implications across a wide range of markets. The rise of the U.S. economy in the mid-20th century, the post-war rebuilding of Japan and Western Europe in the late 20th century and the 21st century rise of the East Asian capitalist-induced production miracle have all been trends that have improved our standards of living. We have been writing about the opportunities available in developing economies of East Asia and Latin America since the year 2000 and our investment decisions since then have reflected that belief. The case could not be stronger for continued growth since the emerging economies, namely China, Brazil and India, are leading the way out of the global recession.

The World Bank estimates that the global economy will contract by 2.9% in 2009 and that the developing world will expand by 1.6% compared to a decline of 4.5% in the industrialized world. This divergence in economic performance is of growing importance since emerging markets account for an increasing share of world output. According to projections by the International Monetary Fund, China is expected to become the largest single contributor to global growth (at 32%) while China, India and the rest of Asia combined will account for more than 50% of the world's collective economic growth in the next five years. This situation is in sharp contrast to the 20 years leading up to 2008 when the U.S. and Europe together accounted for nearly half of the world's growth.

Policymakers in the G-20 economies have spent trillions of dollars in fiscal and monetary stimulus to prevent a repeat of a 1930s-style depression. These measures have largely succeeded in halting the freefall in financial markets and slowing the pace of decline in economic activity. As a result, global equities rallied 17% during the third quarter as measured by the MSCI World index while emerging market equities rallied by 20% according to the MSCI Emerging Markets index. This rally brought returns for global equities up to nearly 23% and emerging markets up to 61% so far this year! For comparison purposes, domestic equities as measured by the S&P 500 index are up 17% year-to-date.

Conditions in global credit markets have also improved dramatically and the growth of the European corporate bond market as an alternative to the U.S. bond

markets has been a very important financing development. The European corporate bond market did not fully develop until the arrival of the single European currency in 1999. Prior to this unification, European companies were dependent on bank loan financing. France and Germany even had regulations until the 1980s and 1990s prohibiting a company from issuing short-term debt in public markets. When the Euro was initially adopted by twelve member states, there was greater transparency of security prices in those member countries. The need for currency hedging was removed and the European Union underwent further de-regulation that stimulated cross-border mergers and acquisitions. As a result, companies not only gained greater visibility outside their home markets, but also had an impetus to issue bonds to fund this activity. In 1999, European corporate bonds represented approximately \$600 billion. As of May 2009, Euro-denominated corporate bonds accounted for approximately 80% (or \$1.7 trillion) of total non-dollar debt outstanding (\$2.1 trillion). (The other 20% was UK sterling-denominated bonds.) This development of the European corporate bond market will continue to assist companies in becoming more competitive globally in addition to providing investors with alternative securities to achieve similar objectives.

As we have forecasted for many years, China continues to be at the forefront of global economic growth. While the country is governed by a “Communist” regime, the leaders have adopted a capitalist economic model that has resulted in nearly a 7% annual growth rate for the first half of this year with an unemployment rate of just over 4%. The government’s moves to encourage lending have caused loan growth to surge more than 20% from year-ago levels. Historically, faster loan growth has translated into stronger economic growth. In fact, the two series have had a 50% correlation over the past decade.

There is an important shift taking place in China that insures further strong growth rates. Domestic consumption is responsible for a larger portion of growth taking its share from the-once-dominant investment component. The trend will likely continue as a growing middle class demands more goods and services on the back of higher incomes. Perhaps this phenomenon is most visible in the auto industry. The auto industry has long been a barometer of the U.S. economy – until now. The 2009 Shanghai Auto Show, historically a showcase for foreign cars, was primarily dominated by China’s own rapidly growing auto industry. China is now the world’s largest car market. While U.S. car sales were down as much as 45% in September, China’s hit an all-time high. And China is not content with being just the largest market. The government’s push towards mass production of electric and energy-efficient vehicles that were on display in Shanghai demonstrates its intent on being the most innovative manufacturer.

The shift of an iconic industry is a good example of the transformation that is taking place in Asia and more importantly in China. The recent financial upheaval

did not affect Asia's economies as much as those in the West. Many Western economies stalled or imploded – Asia's expansion merely slowed. Domestic spending has increased at annual rates of more than 5% during the recent global downturn. The tremendous amount of government spending on infrastructure has also been rewarding for equity investors as Chinese stocks have rallied 45% so far this year.

On the eve of China's 60th National Day celebration, Premier Wen Jiabao stressed the "importance of national unity, social stability, and maintaining the sustainability and stability of the country's macro economic policy". This move to achieve steady and rapid economic development and contribute to global economic recovery confirms China's commitment to continue down the capitalist path. He said that in another 40 years, "when New China embraces its 100th founding anniversary, it would be prosperous, democratic and civilized, reflecting harmonious socialist modernization".

China's acceleration of reforms in their financial system demonstrates the country's desire to remain competitive in the global arena. The government has made a commitment to reforming China's pension system that would help to drive money into fixed income markets. Under-developed bond markets remain a crucial gap in Asia's financial system. The size of their bond markets is dwarfed by the amount of outstanding bank loans. Bond maturities are limited (the majority of bonds mature in 3 to 5 years) so there is no way to invest in bonds for the long-term. If pension reform takes hold and pension funds demand more long-dated corporate bonds, companies in Asia should be expected to increase supply, taking advantage of this market to raise capital for expansion. Companies would then be able to diversify their funding sources and decrease their current overdependence on short-term bank lending. The government has made progress in deepening the capital markets but still has some work to do with regard to strengthening the regulatory framework in terms of improving market transparency and promoting long-term investing in Asia.

China has also pledged to overhaul its health services and insurance systems. In January of 2009, the government passed a \$124 billion plan to provide coverage to 90% of the population by 2011 and to revamp health care infrastructure. Since China's healthcare system is largely operated by the state, these moves to make health care more accessible and efficient should support growth in such industries as pharmaceuticals, medical equipment, hospital services and insurance. Some of these reforms have already come to fruition. A friend of ours moved his family to China a few months ago. He called us in the middle of September and told us that he needed back surgery. He flew back to the United States to meet with doctors and was told that surgery would cost \$100,000. After returning to China, he visited with doctors and was told that the same surgery would cost \$3,000. Obviously, questions come to mind about the expertise of the doctor and the quality of care in

China. Upon further review and discussion, a big part of the cost differential was a result of malpractice insurance premiums and other bloated costs of providing medical care in the United States. He had the operation last week and is resting at home in Xiamen.

The problem in evaluating investment opportunities in China is that there is SO much happening there that is “history-in-the-making.” So let’s look at two other prominent emerging economies, Brazil and India – our other favorite global growth leaders.

At this writing, Rio de Janeiro (the River of January) has been chosen to host the 2016 Summer Olympics and will be the first South American city to host the event. Most people know that Rio is famous for its natural settings, carnival celebrations, samba and other music, and hotel-lined tourist beaches, such as Copacabana and Ipanema. The selection of this city is a sign of the country’s growing importance in the world. Brazil’s economy has rebounded briskly from a sharp but brief downturn. Real GDP growth recovered in the second quarter of this year expanding at an annualized rate of 7.8%. Growth has been led by private sector consumption, much like China, and exports have rebounded. Business confidence indicators point to continued strong growth in the quarters to come and fiscal policy remains positive. The recent acceleration in government spending is unlikely to lose much steam ahead of the general elections in October of 2010 and with the Summer Olympics a little more than five years away, fiscal policy will likely continue to be expansionary – spurred on by the investment needed for the summer games. One risk might be a tightening of monetary policy in the face of rising commodity prices. Yet Brazil has handled rising energy prices in stride since the country is heavily reliant on sugar cane for fuel as opposed to heavy crude. Virtually the entire auto fleet runs on ethanol that is produced domestically.

In January of this year, we discussed the importance of the G-20 versus the G-7 since the former includes emerging economies such as Brazil, China and India. Interestingly, the Brazilian Finance Minister, Guido Mantega, has recently proposed increasing the influence of developing nations at the International Monetary Fund. With his RIC-comrades, Mantega will continue to push for greater representation at the Washington-based lender.

The underlying fundamentals for investing in Brazil remain appealing. The economy’s robust recovery, very low-by-historic standards interest rates (the Selic rate was cut 500 basis points to 8.75% earlier this year) and favorable fiscal policy has driven stocks higher by 27% during the quarter bringing year-to-date returns to 97%. Companies and investors continue to be bullish about the economy’s resilience and the market’s prospects. The third quarter was the most active for capital market operations so far in 2009. Seven companies went to the market with initial and secondary offerings, raising nearly \$7 billion. (Moody’s Investor

Services recently upgraded Brazil's sovereign credit rating to investment grade). Moreover, giant Banco Santander (Spanish-owned) recently raised more than \$8 billion from an initial public offering of shares in its Brazilian subsidiary. The IPO could prove the largest in the world this year. Ironically CNBC World, the investment-oriented cable station, spends virtually no time reviewing news from South America while having extensive coverage on Russia and India.

Moving East to India we find a similarly positive story. Moviegoers got a first rate look at both the old and new India when they viewed the latest Academy Award winner: "Slumdog Millionaire," a story about a boy who rises from the slums of Mumbai and wins a huge fortune on the American-based game show "Who Wants to Be A Millionaire". The movie was filmed in India and presented both the slums and the explosion of new high-rise homes that have characterized India's economic growth model over the past few years. India's common language with the West combined with their talented and well-educated population has created a natural relationship for American and European companies to outsource many service components of their businesses. For years, India's big tech firms positioned themselves as a cheap alternative to Western competitors for tasks such as software maintenance and database upgrades. Now, India's \$60 billion-a-year technology services industry – a flagship of the nation's economic surge in the past decade – faces challenges from the global economic downturn and increasing competition in the tech services industry worldwide.

Despite the recent downturn, the government has slowly and steadily addressed a number of critical structural issues enabling the acceleration in economic growth to 9% per year from 2003 to 2008. Growth for the next two years is forecast to come in at a much slower 6-7% rate, still the second-fastest expanding major economy in the world. Manufacturing, mining and power generation are recovering yet unemployment still remains stubbornly high. The majority of Indians work in agriculture (60%) and are unskilled. Their relationship with the land is very important culturally and persuading individuals to release land for development has long been a political problem for India. Recently, it was reported by The Financial Times that ArcelorMittal was close to pulling out of a \$20 billion plan to build two large steel plants in the states of Jhark and Orissa. Delays in persuading farmers and others to sell the land needed for development were unreasonable. As a result, the company will be forced to look for other places to expand. Despite this capital investment deal gone sour, there has been a slow and steady recovery in private equity and venture capital deals in the past quarter. Foreign institutional investors who had withdrawn \$12 billion in the last fiscal year have made net investments of \$10 billion so far this year.

Moreover, the World Bank approved the largest ever annual loan package (\$4.3 billion) to India as it sought to speed the country's recovery from the global economic downturn with targeted support for the banking sector and

infrastructure development. The worst of the crisis appears to be over but doubts persist over the strength of the comeback despite a remarkable monetary and fiscal response by the government. A key area of concern is credit growth. Although India's banking sector had little exposure to the toxic assets that created havoc elsewhere, \$2 billion of the loan package is intended as a capital injection for banks. The move is designed to strengthen the capital of state-owned banks in a largely unreformed sector still dominated by large public institutions and to stimulate credit to business and the rural economy. Demand on public sector banks has increased as private and foreign banks have slowed their lending and deposit taking.

The newly elected Congress-led government has plans to spend \$100 billion on infrastructure over the next three years. This spending proposal also comes as New Delhi, the country's capital, is struggling to improve its sporting and transport infrastructure ahead of next year's Commonwealth Games. The problem is that the amount of skilled workers available is low and particularly acute against a backdrop of falling foreign investment. A lack of skills threatens to retard the aggressive push to improve the national road network. These issues pose major risks to the planned rapid catch-up on road sector investments. A recent report from the World Bank estimated that India had about 110,000 highway engineers. China had five times that number when it upgraded its road infrastructure in the 1990s.

Nevertheless, investors are bullish about the long-term prospects for Indian companies and continue to be rewarded. India's benchmark Sensex index has risen more than 70 per cent so far this year, making it one of the 10 best performing markets around the world.

We are at a turning point in the global economy. After an early 21st century spurt in real growth, the decade's first global recession engulfed both developed and emerging economies. Timely intervention by governments permitted a smooth transition to a new period of economic growth triggered by emerging economies and their desire to improve their citizens' standard of living. In this process there will continue to be unusual investment opportunities and our investment strategy is designed to participate in this global expansion.

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