VICTORIA
Capital Management, Inc.

Global Financial Markets Perspective
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Globalization and Wealth Creation

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The integration of different economies in order to make them more competitive is globalization. In other words, globalization is the increasing interdependence, integration and interaction among people and corporations around the world. The emergence of globalization stems from post-WWII economic policy that encouraged free trade. Today, world wealth creation is at a record high as cross-border investment has soared. Competition and free markets have allowed companies to take advantage of low costs of capital and labor. Wealth creation has been the obvious outcome.

Wikipedia[1] further elaborates on globalization in a way that fits well within our view of the global economy and financial markets:

- *industrial* globalization (trans-nationalization) - rise and expansion of multinational enterprises
- *financial* globalization - emergence of worldwide financial markets and better access to external financing for corporate, national and sub-national borrowers
- *political* globalization - spread of political sphere of interests to the regions and countries outside the neighborhood of political (state and non-state) actors
- *informational* globalization - increase in information flows between geographically remote locations
- *cultural* globalization - growth of cross-cultural contacts

These five components of globalization have positively affected the investment climate by providing a myriad of growth opportunities over the years. More importantly, globalization has transcended politics — no longer is capitalism the by-product of democracy; rather this phenomenon can be found in countries governed by communists, socialists, and monarchies. America's greatest challenge will be to survive the powerful economic force of a country whose people are capitalist by nature and are encouraged by a government that is unfettered by diverse political agendas.

As our regular readers know, we have been proponents of investing in foreign markets since 1992[2]. At the beginning of 2004, we re-introduced our "Global Growth" theme that included companies from Latin America, Eastern Europe and Asia. Indeed, our first quarter perspective last year focused solely on the "Asian Miracle". So despite the fact that the Dow Jones industrial average has finally, after six years, moved into record-breaking territory, a reflection of years of strong corporate profits, remarkable gains in productivity and the willingness of American consumers to spend, there are still pessimists who feel that they have not benefited from globalization — nationalists who prefer localization.

Not only has the world just completed four years of the strongest global growth since the early 1970s, but also in 2006, cross-border trade as a share of world GDP pierced the 30% threshold for the first time ever — almost three times the portion prevailing during the last global boom over thirty years ago.

Moreover, global trade linkages have broadened across all major regions, with global trade as a share of GDP expected to exceed $14 trillion, or 30% of world GDP this year. From 1987 to 2005, global trade accounted for 36% of global GDP growth, more than double the 17% seen during the 1974 to 1986 period. According to IMF estimates, world trade volumes of goods and services will have grown nearly 9% in 2006, well above the 7.5% longer-term growth trend. Technological advances contributed to a sharp reduction in costs for transportation and telecommunications companies resulting in increased trading activity. This more inclusive trading system has also generated tailwinds for economic growth and recovery.

Latin America has been a major beneficiary of globalization through free trade. The region has benefited from a period of unprecedented demand that has boosted prices for commodities from the region and contributed to a prolonged period of above-trend U.S. growth and low interest rates. Latin America is benefiting from the emergence of economic stability and a dose, however partial, of political certainty. In a region where growth has frequently been punctured by crises that have brought down currencies, economic models, and heads of state, the mere fact that 2006 marked the fourth year of good growth and low inflation is an important accomplishment. This change in stability brought about by globalization can clearly be seen in Brazil. Just four years ago this month, Brazil watchers (including us) were engaged in a debate over whether the country was on a path leading to debt default and capital controls. Today, Brazil has zero net public external debt, declining domestic debt, and inflation hovering around 2-3%.

Looking elsewhere in the region, Mexico has benefited from globalization and free trade thanks to Vincente Fox and Felipe Calderón. Felipe Calderón, who was elected last year, is for free trade and low tax rates that should continue to positively influence Mexico’s economy. Low inflation — core inflation has been running within Banco de Mexico’s target range for the past four years — has resulted in the creation of mortgages and credit for those who had long been beyond the reach of financial intermediaries. That trend is likely to continue uninterrupted in 2007 and provide a significant cushion to a slowing export-based manufacturing sector.

Now five years into the current growth cycle in Latin America, we have seen little of the excesses of past upturns in the region. The current expansion has not produced the ballooning trade and current-account deficits fueled by consumer spending seen in the past, nor widening fiscal deficits, nor the spectacle of central banks burning through reserves to prop up woefully overvalued currencies. Thus, while the region is hardly immune to a potential global slowdown, we suspect the consequences would be much milder than in the past and would ultimately strengthen the region’s newfound stability.

Globalization in the European Union (EU) includes all five aspects of Wikipedia’s definition. The European Union was set up to bring peace, stability and prosperity to Europe. Europeans have achieved a successful integration that has not smothered the different ways of life, traditions and cultures of its peoples. Indeed, the EU makes its diversity one of its key values.

Industrial globalization has spurred a structural decline in unemployment while policies aimed at reducing the cost of low-skilled jobs (by cutting social contributions) have worked, but their unwelcome side effect was the creation of two-tier labor markets. Dual labor markets have generated economic inefficiencies and social tensions. As a result, governments will have to consider more far-reaching reforms, such as relaxing wage-bargaining systems, removing obstacles to redundancies or simplifying labor contracts. Labor market policies are likely to be hotly debated ahead of the French presidential election but could also return to the forefront of political debate in Italy and Germany. The risk is a sudden upsurge in localization and trade disputes.

The Italian government’s initiative to liberalize the services sector in the face of globalization is the first step in encouraging competition that should reduce Italy’s exposure to the internationally competitive and volatile manufacturing sector. Reforms of this nature are essential to growth in the economy and the future of Italian companies. Politicians will have to continue to push for these reforms to benefit from globalization or risk reverting to localism that would crimp economic growth.

German companies are not restructuring to take away market share from their French, Italian or Spanish competitors. They are restructuring to survive in the face of low cost competition from Central and Eastern Europe and Southeast Asia. As a high-wage country with above-average exposure to export destinations outside of the European Union and a traditional capital exporter, Germany was the first to feel — and to react to — the gales of globalization and their impact on the relationship between capital and labor seen in many industrialized countries.

An example of failing to embrace globalization is France (are you surprised?). French exports outside of the European Union (EU) are 16% lower than at the outset of the union in 1992 (for interested readers, the Maastricht Treaty created the current European Union). Comparable numbers for Germany, Italy and Spain are respectively +11%, -1% and +2%. In this competitive game, France is the loser, Germany is the winner, while Italy and Spain have broadly maintained their relative positions. Ample liquidity, rising cross-border capital flows within the European Union and divergent dynamics in domestic demand among the 27 members have fueled rising current account imbalances resulting in political tensions.

Slower growth and large war chests accumulated in previous years make companies more aggressive increasing tensions in the EU. Taking a long-term view, political leaders seem to have largely underestimated the practical implications of the European Monetary Union and of the EU enlargement. However, corporations embrace the EU as capital easily crosses borders. Restructuring has become a permanent and obsessive theme for European companies. The result is that companies operating on a pan-European basis with global ambitions have a growing influence on economies, while governments have less. The tug-of-war between the power of capital moving freely across borders (while most workers won’t) and institutions changing slowly, creates investment opportunities for global investors. Countries with the least political resistance to these globalization efforts will find the emergence of multinational companies operating from their historical European base.

In Asia, the increasing level of globalization has meant that economic and financial market cycles have tended to move in a synchronous manner with those in the United States. This case is particularly so in China as both industrial and financial globalization have impacted the economy resulting in criticism of the Chinese government's currency policy. In Beijing, the capital of China, Federal Reserve Chairman Ben Bernanke offered the Chinese some good advice in a speech he gave as part of the newly-instituted Strategic Dialogue discussions that were just held between the U.S. and China in December. Unfortunately, he also offered some questionable advice in assessing the ramifications and risks of Chinese currency policy. The Chinese have loosely pegged the renmimbi to the U.S. dollar — otherwise known as a managed float. The offensive passage in the written version of the Bernanke speech posted on the Fed's website was the assertion that the current value of the Chinese renmimbi is an "…effective subsidy that an undervalued currency provides for Chinese firms that focus on exporting rather than producing for the domestic market." The use of the word "subsidy" is a highly inflammatory accusation — in effect, putting the Chinese on notice that America's most important macro policy-maker believes that renmimbi currency policy provides the Chinese with an unfair advantage in the world trade arena that fosters distortions in China's economy, the U.S. economy, and the broader global economy. Little attention is given to the context in which these currency policies are being formulated and, ironically, fails to provide any appreciation for the benefits that accrue to America as a result of this so-called subsidy.

Conveniently overlooked is the important flip side to the managed float that continues to drive currency policy — China's massive purchases of dollar-denominated financial assets. The exact numbers are closely held, but there is close agreement that between 60-70% of China's $1 trillion in official foreign exchange reserves are split between some $345 billion invested in U.S. Treasuries (as of October 2006, according to the US government's TIC reporting system) and a comparable amount held in the form of other dollar-based fixed income instruments. Chinese reserve accumulation is now running at over a $200 billion annual rate that implies new purchases of dollar-denominated assets of at least $120 billion per year. As a low-cost and increasingly high quality producer, China is also providing a subsidy to the purchasing power of U.S. households. Hinder trade with China through tariff barriers — as many in the U.S. Congress wish to do — and the deficit would show up somewhere else, undoubtedly with a higher-cost producer. This event would be the functional equivalent of a tax hike on the American consumer — cutting into the subsidy the U.S. currently enjoys by trading with China.

The potential currency volatility that a fully flexible foreign exchange mechanism might produce could have a destabilizing impact on an undeveloped Chinese financial system. And that's the very last thing China wants or needs. China has special transitional needs associated with its still blended Chinese economy — currently straddling both state and private ownership systems, as well as centrally-planned and market-directed allocation mechanisms. Imagine the Chinese government's need to employ 25 million new workers each year! Hence, full financial globalization will take some time.

The Chinese government has been claiming success in macro tightening, reporting slower economic activity in response to administrative controls in the last few months. Recent Peoples Bank of China (PBoC) rhetoric has shifted the policy focus to liquidity management, through lifting reserve requirements and/or issuing bonds. In 2006, the PBoC hiked interest rates twice and raised reserve requirements on renminbi deposits three times. Meanwhile, issues of central bank bonds have been kept up to absorb liquidity from the banking system. While the bond issuance program has been far from aggressive, this financial globalization effort has resulted in a friendly liquidity environment for investors in China.

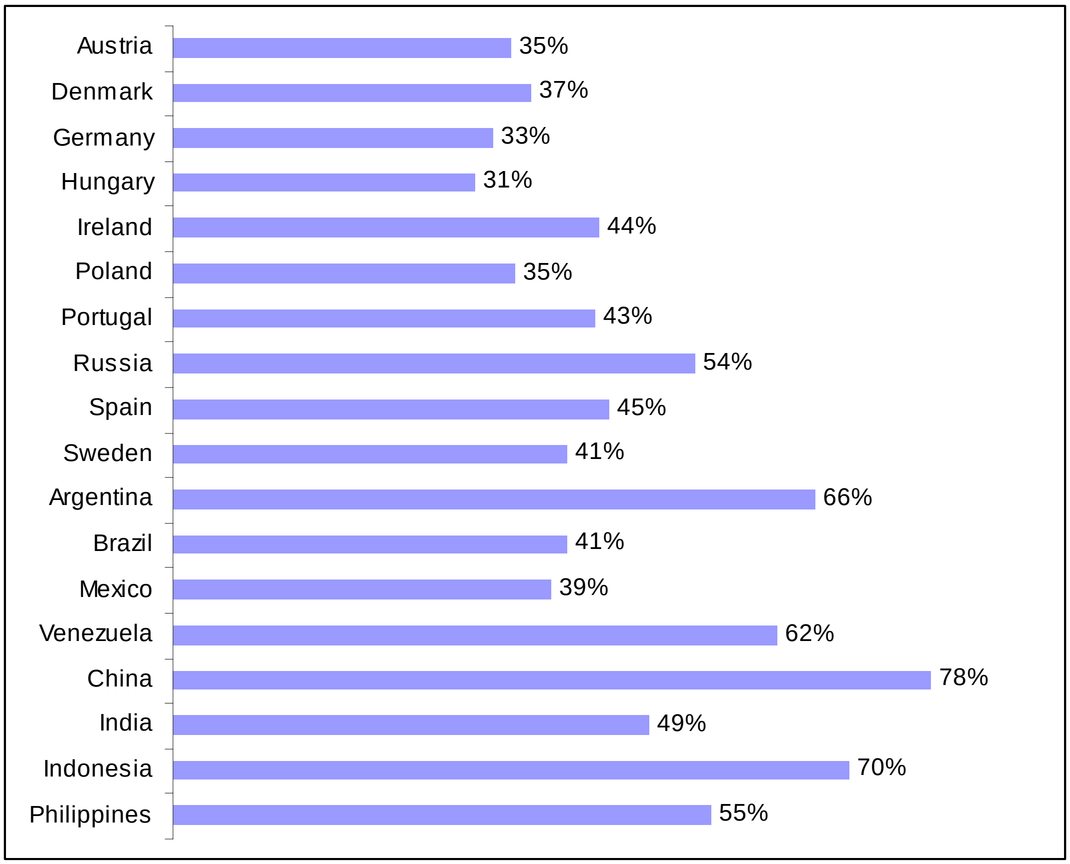
Liquidity conditions and asset market performance in China have a strong influence on real economic activity in Hong Kong. The influence has further stepped up this year on the back of the increase in large-size listings of Chinese enterprises in the Hong Kong stock market. The Hong Kong dollar-denominated financial asset base has grown significantly, powering monetary expansion far ahead of economic growth. The expansion of Hong Kong's financial asset base in the last few years has been driven by China's increasing appetite for international capital. The performance of the asset markets is not so directly representative of Hong Kong's domestic economic fundamentals, but ironically has become the driver of monetary conditions and economic sentiment. Stock market capitalization has surged to more than HK$12 trillion, more than 8 times GDP — another positive result of financial globalization. Incidentally, few U.S. politicians complain about the HK dollar peg to the U.S. dollar.

We believe that the U.S.-China relationship could well be the most important bilateral underpinning of successful globalization. Increasingly the economic tensions between these two nations are in danger of being politicized, with the nation-specific considerations of localization increasingly taking precedent over globalization. The recent shift in the political alignment of the industrial world to pro-labor left from pro-capital right will put further pressure on globalization efforts. Labor costs easily account for the largest portion of business expenses, a fact that has proved to be a veritable bonanza for return to capital — pushing the profits share of national income in the major countries of the industrial world to historical highs of 15.6%. In days of yore — when labor unions actually had bargaining power — the squeeze on labor income in the developed world would have likely resulted in some form of a "worker backlash". In today's increasingly globalized world, however, workers have no such power. But their elected political representatives most certainly do.

America is not alone in tilting to the pro-labor left. In France, the ascendancy of Ségolène Royal, who was nominated by the socialist party to run for president in the upcoming election this April, offers a modern-day mix of pro-labor politics with a protectionist bias. Italy's Prime Minister Prodi is also pro-labor, and in Spain, Prime Minister Zapatero is certainly more sympathetic to the plight of labor than Aznar was. In Germany, Chancellor Merkel has tilted increasingly toward labor after she nearly lost the election running on a pro-market reform agenda. The new Abe government in Japan has teamed up with the center right in support of the "second chance society" — attempting to make certain that the victims in the rough and tumble arena of global competition are given the opportunity to come back. And in Australia, Kevin Rudd, the newly anointed opposition leader, seems set to center his platform on the struggle of the average worker.

If the self-interests of nation-states become increasingly dominant, the pendulum of political power might swing from globalization to localization. This move would imply very different characteristics for the macro-economic climate. The most obvious — wages could go up and corporate profits could come under pressure. Pro-labor politicians could also direct regulatory scrutiny at excess returns on capital — focusing, in particular, on the perceptions of excess returns in financial markets (i.e., hedge funds and private equity) as well as on the inequities of rewards at the upper end of the income distribution (i.e., tax cuts for wealthy citizens and the excesses of executive compensation). Moreover, localization taken to its extreme could also spell heightened risks of protectionism — especially if the global economy slows and unemployment starts to rise in 2007. Under those circumstances, inflation could accelerate, leading to higher interest rates, greater volatility in financial markets, and a potentially vicious unwinding of an over-extended credit cycle. And, of course, the protectionist ramifications of localization could prove equally challenging for the beneficiaries of globalization's first win — dynamic new companies in the developing world and the employment growth they generate.

Is globalization working? One of the better indicators is world equity markets that provided stellar returns last year as illustrated in the following exhibit.



Equity markets are typically a barometer for future economic conditions. The surge in global equity prices during 2006 suggests an above-average year for growth in the global economy. This growth will find its way into demand for U.S. exports that will have a positive effect on the bottom line of corporate profit statements. Corporate profits growth has been more than just strong, it's been gangbusters. The most recent data showed the fastest growth pace since 1984. As a share of GDP, pre-tax profits posted a 12.4% return (the highest since 1950) while after-tax profits posted a new post-WWII record at 8.8%.

We believe that the standout profits numbers bode well for a soft landing and stronger growth in 2007. Additionally the rally in global equities does not portend a recession but rather stronger global growth. As they say, past performance is no guarantee of future results. We are confident that barring external shocks, global financial markets and the economy are more dynamic than not and offer more opportunities than risks. However, the scape-goating of China remains a most unfortunate feature of current globalization trends. U.S. politicians want to pin the blame on China for America's trade deficits and wage pressures bearing down on U.S. workers. A new wave of economic nationalism or protectionism would concern us and could frighten global investors. Let's hope the U.S. Congress and other foreign politicos don't regress to localization.

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[1] Since its creation in 2000, Wikipedia has rapidly grown into the largest reference Web site on the Internet. The content of Wikipedia is free, and is written collaboratively by people from all around the world. Because Wikipedia is an on-going work to which in principle anybody can contribute, it differs from a paper-based reference source in some very important ways. In particular, older articles tend to be more comprehensive and balanced, while newer articles may still contain significant misinformation, unencyclopedic content, or vandalism. However, unlike a paper reference source, Wikipedia is completely up-to-date, with articles on topical events being created or updated within minutes or hours, rather than months or years for printed encyclopedias. Now that's globalization!

[2] In 1992-94, I was fortunate enough to work for Frank Cappiello in the role of portfolio manager for his investment firm. I was responsible for managing a variety of international closed-end funds and gained an appreciation for the emerging investment opportunities presented by globalization.